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Section Chair Andrea Seidt
Project Group Chair Dale Cantone
North American Securities Administrative Association, Inc.

RE: NASAA SOP Regarding the Use of Franchisor Questionnaires and Acknowledgement

Dear Ms. Sedit and Mr. Cantone:

I write in support of the NASAA SOP regarding franchisor acknowledgements, questionnaires and other provisions designed to disclaim franchisor fraud and liability under state franchise disclosure laws.

1. *Statement of Background*

I have been representing franchisees and their associations for over forty years. I was first involved in franchise litigation as a young staff attorney prosecuting the first action under the FTC Franchise Rule. In that case, *FTC v. H.N. Singer, Inc.*, 534 F.Supp. 24 (N.D.Cal. 1981), *affd.*, 668 F.2d 11207 (9th Cir. 1982), on behalf of the Federal Trade Commission we obtained an *ex parte* freeze order of a franchisor and its principals' bank accounts, and eventually the return of substantial sums invested by franchisees as consumer redress. Since 1982, I have represented thousands of franchisees including over one hundred trials and arbitrations to judgment or award.

During my over forty-year career, I have reviewed hundreds of FDDs and franchise agreements from all manner of franchise systems. I have observed changes in franchise agreements over the decades and written articles about provisions including on the misuse of integration, no representation and no reliance clauses by franchisors, and separately on the commonality of provisions in franchise agreements.

I am a certified specialist in franchise and distribution law by the Office of Legal Specialization of the State Bar of California. I have written and lectured extensively on franchise law including with the American Bar Association, the International Franchise Association, the State Bar of California and several other Bar Associations. I served on the Board of Governors of the American Bar Association Forum on Franchising, as an Advisory Attorney to the NASAA Franchise Advisory Group, and I have taught franchise law at two Universities.

2. *The Need for the SOP regarding Franchisor Acknowledgements, Questionnaires, and Other Provisions*

The proposed SOP is warranted and long overdue (I have also repeatedly advocated for this type of change consistently in proposed modifications to the FTC Franchise Rule). The state franchise disclosure laws were designed to stop fraud and misrepresentation by franchisors in the offer and sale of franchises, and to require disclosure of specified truthful information to level the information imbalance that franchisors have over franchisees.

A. *The Purpose of State Franchise Disclosure Laws is Franchisor Disclosure not Franchisor Disclaimers*

The purpose of the state franchise disclosure laws is not to provide franchisors a forum for disclaimers from liability for fraud and other misconduct. But this is precisely what franchisors have increasingly done over the last forty years. First, to this end, franchisors used integration, no representation and no reliance clauses, and later they used acknowledgements and questionnaires. Franchisees are asked to sign such disclaimers when the sales transaction is consummated at the time of franchise agreement signing and initial franchise fee payment.

All three of the franchisor techniques – acknowledgements in the FDD or franchise agreement, questionnaires in the FDD, and contract fine print provisions – seek to waive franchisee's rights to bring actions for franchisor fraud and misrepresentations in the sales process. These franchisor disclaimer provisions violate the letter and spirit of the state disclosure statutes. In most states these franchisor provisions directly defy, and are illegal, under the statutory anti-waiver provisions.

The proposed SOP primarily addresses acknowledgements and questionnaires which often are included in the FDD. But disclaimers have also been accomplished by fine print contract terms for decades. First, no representation provisions (distinct from the integration clauses themselves) represent that the franchisee received no representations outside the FDD or in conflict with the FDD (see my seminal article on these provisions *The Misuse of Integration, No Reliance and No Representation Clauses in the Name of Contract Certainty*, 18 Franchise Law Journal 3 (1998). The issue of misrepresentations in franchise sales should be decided based on evidence of what occurred during the sales process, not on fine print that says nothing was said. The fact finder should decide the credibility of testimony, emails, magazine articles, pro formas, oral statements and more rather than throwing the franchisee out of court due to a non-negotiated contract term. Second, no reliance provisions represent that franchisee relied on nothing beyond the FDD. This is preposterous since the typical franchisee receives dozens of calls, emails and meetings with franchise salespersons who are avidly seeking to obtain a franchise sale. The concept that a franchisee must sort out what information was inside the several hundred-page FDD and what was outside the FDD is preposterous (and were they presented in a court would lead to a sustained compound and complex question objection). Proof of this is that the essence of a no reliance clause is that the prospective franchisee must assume that everything the franchisor and its salespersons stated during the sales process is false or should not be relied upon. Moreover, properly applied, state franchise disclosure laws should not require *justified* reliance for franchisee recovery. Instead, franchisees should be entitled to relief under the lesser standard of actual reliance. *See, Lessons from Thucydides on Distinguishing Statutory from Common Law Fraud in Franchise Disclosure Actions, 35 Franchise Law Journal 20 (Spring 2016); Randall v. Lady of America Franchise Corp., 532 F.Supp.2d 1071 (D.Minn.2007).*

B. *The Prime Example of Franchisor Avoidance of Statutory Disclosure Obligations is Financial Performance Disclaimers*

The clearest example of misuse of disclaimers by franchisors involves financial performance representations. The franchisor provisions (whether in acknowledgements, questionnaires, or contract terms) all recite that no additional financial performance representations are made except what is in the FDD. The reality is such representations are often, if not regularly made, and are often false or misleading. This is precisely the conduct which the state franchise statutes are designed to prevent – and so provide is illegal. But franchisors routinely use these acknowledgements, questionnaires and contract terms to argue that the franchisee cannot assert in court what it denied at the time of sale. Despite that, it is the franchisor which has the disclosure obligations and is not entitled to make additional representations outside the FDD nor false and misleading representation. And when franchisors assert that they would not proceed with the sale without such disclosures., they are really stating they do not want to proceed with sales unless they are insulated from fraud liability. But this is barred by the anti-waiver provisions and by common sense.

Additional representations by franchisors are especially common regarding financial performance and come in many ways. Franchisees receive copies of news articles with financial performance data, or see the articles posted at the franchisor's headquarters during discovery day or are directed to the articles. Franchisees are told financial representation data orally by franchisor salespersons. Other methods include pro formas with financial data already filled in or provided over the telephone by franchisor personnel. And there is a good reason that these financial performances representations are so common; no matter how experienced or sophisticated, most prospective franchisees want financial performance data before they buy. If it is not present (about 40% of FDDs leave it out altogether) or is incomplete (many of those disclosing financial data in the FDD only give sales data without the all-important profit and loss data or give limited profit and loss data) then the franchisee will seek the information.

Acknowledgements, questionnaires and contract clause should never disclaim franchisor liability when financial performance representations, especially false ones, are made outside the FDD to prospective franchisees. Nonetheless, franchisors use such provisions to defend themselves from liability for common law and statutory misrepresentations in the sale of franchises. Sometimes these defense arguments are successful, and the franchisee's claims are wrongly dismissed as mentioned in the proposed SOP.

The definitive case on the illegality of financial performance representation outside or differing from the disclosure document is *FTC v. Minuteman Press*, 53 F.Supp.2d 248 (E.D. N.Y. 1995). The FTC brought a complaint against the related franchisors of Minuteman Press and Speedy Sign-A-Rama, plus some of their officers, for making financial performance misrepresentations (then called earnings claims) outside the UFOC. The district court found that the mere fact that additional earnings claims were made violated the FTC disclosure rule without regard to the truth or falsity of the additional representations:

> Each corporate defendant filed UFOCs to comply with the disclosure requirements of the FTC Act and Section 436 of 16 C.F.R. In those

> documents, the franchisor indicated that no earnings claims were being made, and that none of the officers, directors or employees were authorized to make such statements. Nonetheless, as noted previously, such representations were made on a regular basis to prospective franchisees. That conflict, *viz.,* between the disclaimers in the UFOCs and the representations embodied in the sales presentations, is violative of the Franchise Rule. 16 C.F.R. Section 436.1(f); Final Interpretative Guides, 44 Fed.Reg. at 49,971.
> *I*d., 53 F.Supp. 2d at 259.

By their no representation and no reliance clauses, in whatever form whether contract terms, acknowledgements or questionnaires) franchisors are seeking to insulate themselves from liability for violations of the state franchise disclosure laws and this should be prohibited.

C. *Franchisor Objections to the Proposed SOP are Groundless and Ignore the Statutory Language and Purpose*

Among the franchisors' assertions against the proposed SOP are that it interferes with their policing of their salespersons and, perhaps more generally, that the proposed SOP interferes with freedom of contract. These objections are groundless and beside the point as they seek to overrule the state franchise statutes which address sales practices prior to the entry into a contract.

Franchisors assert that they seek by questionnaires to determine if their salespersons violated the statute by making impermissible financial performance representations. But policing the conduct of franchise salespersons is the obligation of the franchisor not the prospective franchisee. The franchisor can, and should, implement internal controls including actual observation of the conduct of their salespersons. The use of compound legalese that franchisees need to agree with to proceed with the franchise they are invested in is inappropriate. And it is contrary to the franchise disclosure laws' purposes and anti-waiver provisions.

Acknowledgements and questionnaires are especially pernicious due to the nature of the franchise sales process. Franchisees receive brochures, written materials, peruse websites, may have dozens of calls with franchise salespersons, typically attend an all-day or multi-day sales process called Discovery Day, follow-up calls and more. One tiny portion of the sales process is the written FDD, which is typically several hundred pages of dense if not legal writing. To expect franchisees to recall what information they received during the extensive sales process versus what was only in the dense FDD is a bridge to far. And franchise salespersons all the while are working on building trust by the franchisees.

The second argument is simply a Chicago school of economics or law and economics trope. That doctrine believes that free and unfettered markets will best serve the economy. The corollary argument made by the Chicago school is for freedom of contracts, that contracts are sacred and must be enforced. But even Chicago school founders, like Milton Friedman, admitted that fraud and misrepresentation are improper and defeat a functioning free market. Private parties, here franchisors, are not entitled to contravene public policy statutes by fine print contract terms.

3. *Modifications to Consider*

The proposed SOP in Item 2(C)(3) on page 8 should change “or” to “and” on the first line to read: “3. Franchisor must include in its FDD, its franchise agreement, **and** applicable state specific addenda to the FDD and franchise agreement the following provision:” (Bold emphasis added for illustration of the requested change). The provision should be included in the FDD, the franchise agreement, and state specific addenda.

The proposed SOP should be strengthened by providing that FDDs and embedded contracts which contain disclaimers are illegal and will not be registered. Such guidance will inform regulators and practitioners of what is permissible in FDDs and embedded franchise agreements and what is impermissible and should be removed. The problem of allowing proscribed provisions in franchise agreements, despite statements that such provisions are void, arises with out of state choice of law and venue clauses. Today most franchise agreements also contain provisions which specify that all claims arising from the contract, or the franchise relationship, are to be governed by the law of the of the franchisor’s home state and provide for venue in that state. The franchisee’s home state’s laws and regulations can sometimes effectively be overridden by such provisions. For example, California’s non-compete proscriptions, despite being important California public policies and clearly intended to protect franchisees operating in California, have been ignored by out of state courts enforcing an out of state choice of law provision. *See, e.g., PostNet International Franchise Corporation v. Wu*, 521 F.Supp.3d 1087 (D. Colo. 2021). Similar problems exist with state franchise law proscriptions of out of state choice of venue, namely some courts have ignored the state franchise law provisions.

4. *Conclusion*

The proposed SOP is long overdue. Franchisors should not have get-out-of-jail-free cards by disclaimers, whether in FDDs or franchise agreements and whether in acknowledgements, questionnaires, no representation clauses and no reliance clauses. These provisions make a mockery of the entire disclosure process and are vigorously used to that end by franchisors and their counsel. The SOP is a strong step toward righting the ship.

Very truly yours,

Peter C. Lagarias

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