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The Registration Experience: Six Easy Lessons from the Converted

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If you have registered a few dozen Uniform Franchise Offering Circulars ("UFOCs") and spent the better part of 2008 converting your current stable to the Amended Rule's disclosure format, you can probably relate to the throbbing headache we experienced during this spring's annual filing season when we registered our clients' freshly converted franchise disclosure documents ("FDDs") with state franchise agencies. Before the annual spring filing crunch, we had found clear sailing in registering FDDs early.

As it turns out, we were not smarter earlier in the process; state examiners had not received training in the details of the Amended Rule until March, after which they turned up the heat. Part of the challenge this spring was in finding state examiners preoccupied with their own learning curve, mastering the FDDs' subtleties and devising state registration policies along the way. We would like to share the top six lessons we learned from this spring's inaugural filing season under the Amended Rule.

Lesson One: Follow Instructions Explicitly

When the UFOC was last overhauled in 1993 and ushered in the Plain English disclosure era, a few state franchise examiners embraced the job of Plain English police and quickly spread religion by rejecting UFOCs containing any Fancy English reference.

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Fast forward, and Plain English enforcement seems light by comparison with the meticulous scrutiny that state franchise examiners applied this spring to make sure converted FDDs exactly complied with the myriad of formatting and stylistic features prescribed by the Amended Rule. Examiners were quick to issue comment letters citing harmless deviations that drilled down to the exact words and fonts required for FDD charts and disclaimers. Examiners seemed more focused on non-material technicalities bearing little on a franchisee's investment than with substantive disclosures. Add to this the slower-than-normal turnaround of renewal applications due to the FDD filing overload, coupled with the fact that many states refuse to embrace e-mail or fax in communicating their comments with applicants, and one can easily appreciate the exasperation shared by so many franchisors and their legal counsel over the regulators' hyper-technical enforcement of non-material disclosure rules. State franchise examiners explained that their new regulatory focus aims at facilitating a prospect's side-by-side comparison of franchise programs by ensuring uniformity in the basic FDD template.

The lesson for franchisors: Use precision in following the FDD format rules, or expect delays in getting registered. Don't improvise with formatting or style rules even if they do not apply perfectly to your client's franchise system. Put in bold font the exact statements or headings that the Amended Rule requires be in bold (e.g., Items 9, 11 and 17), and capitalize the exact words of the disclosures that the Amended Rule requires be in capital letters (*e.g.*, State Cover Page, Items 11 and 17). Keep the FTC cover page and the state cover page separate. State the total investment necessary to begin operation of the franchise in one sentence; don't use a narrative even if the narrative might explain material assumptions underlying the numbers. While North American Securities Administrators Association ("NASAA") says state franchise examiners will treat the FDD's format rules as suggestions, that was not our experience.

Lesson Two: Obey New Rules on Integration Clauses

Since NASAA years ago added a state addendum exhibit to the UFOC and began facilitating a franchisor's use of a single disclosure document in all 50 states, franchisors have been allowed to put substantive contract terms dictated by state franchise laws, such as mandatory venue and choice-of-law provisions, in a state-specific contract addendum which only franchisees operating in that state would sign. The state-specific addendum meant that franchisors no longer needed separate disclosure documents and contracts for specific states. Registration states tacitly yielded to a policy of not meddling with the basic franchise agreement except through the state-specific addendum.

This spring, regulators reversed themselves on one issue, contract integration clauses, a subject which regulators have consistently viewed with heightened suspicion. Contract integration clauses rub against a fundamental public policy underlying pre-sale disclosure laws: If literally applied, a sweeping integration clause would wipe out all prior statements, even those in the FDD. The FTC directly addressed contract integration clauses for the first time in the Amended Rule by forbidding a franchise seller to disclaim, or to require a prospective franchisee to waive reliance on, any statement in the FDD, while making clear that the Amended Rule does not ban these clauses altogether.

In early April, Maryland began refusing to register any FDD unless the franchise agreement's integration clause included the following statement: "Nothing in the Agreement is intended to disclaim the representations we made in the franchise disclosure document that we furnished to you." By May, the rest of the registration states followed suit. Despite protests from some members of the franchise bar that regulators were inappropriately meddling with the parties' substantive relationship, regulators stood firm, forcing franchisors to add the special language in the body of their contract or to forget registration.

The new policy does not outlaw a franchisor's use of a closing questionnaire. Franchisors may still ask franchisees to acknowledge that they are buying the franchise without relying on anything outside the franchise agreement, provided they do not require the franchisee to disclaim content in the FDD.

Lesson Three: Identify All Franchise Sellers

While franchisors have praised the FTC for eliminating franchise broker disclosures from FDD Items 2 and 3, thereby saving franchisors that engage franchise lead-generation networks from having to disclose information about potentially hundreds of brokers who may have no connection to a particular sale, the FTC did not eliminate broker disclosures altogether. By revising the UFOC receipt pages (Item 23), the FTC requires franchisors to identify by name each person with whom the prospect has significant contact before buying the franchise. What remained unclear was whether the receipts had to be supplemented if, after signing them, the prospect had significant contact with additional persons qualifying as franchise sellers. Exactly who is a franchise seller? Is it always a person? What if multiple persons touch the franchise sales activity culminating in a franchise sale? For example, what about a discovery day scenario?

The cascade of questions led the FTC in July to issue FAQ 23. Beyond reiterating that a franchise seller is anyone who makes material representations to a prospect about the franchise, FAQ 23 instructs franchisors to supplement signed receipts before a franchise sale closes in order to add each new franchise seller who later becomes involved in a particular sale. The supplemental receipts do not trigger a new 14-calendar day waiting period. Consequently, the most practical way to accomplish supplementation may be at the closing. FAQ 23 reaffirms that franchisors, not franchisee prospects, bear the burden of making certain the receipt pages identify all franchise sellers.

Lesson Four: Everything in the FDD is Fair Game for Examiner Comments

State regulators have always had the prerogative to issue comment letters about previously registered disclosure content left unchanged in a renewal application, but they rarely did. Over the years, because of budget constraints, a few registration states have adopted risk-based franchise application review, focusing their limited resources just on the most critical enforcement areas, in particular, the franchisor's financial footing.

So what accounts for why regulators this spring began issuing comment letters about so many previously registered disclosures prepared under UFOC Guidelines which the Amended Rule did not substantively change? State franchise examiners, hypersensitive to the FDD's precise wording and organization, seemed to apply a check-off-the-box style of review, especially for those FDD items that reorganize the old Guidelines into new subcategories, such as Item 11. Since shoring up FDD uniformity advances the regulators' policy objective of helping prospects compare franchise programs, regulators showed little constraint in asking franchisors to beef up old UFOC disclosures which the Amended Rule had not substantively changed.

Lesson Five: Not All States Are Going Green

Despite the FTC's validation of a purely paperless e-disclosure process, most states continue to resist a purely paperless registration process. This dismays us. For a dozen years, the federal government has embraced EDGAR, the electronic filing system applicable to securities registration documents. If federal securities regulators could go green years ago, state franchise regulators by now should be able to devise a plan to accept FDD filings electronically via e-mail or CD-ROM.

That said, some franchise registration states are greener than others. We applaud Indiana, North Dakota, Rhode Island, South Dakota, and Wisconsin for taking the lead down the paperless path. The chart on Page 6 details how the registration states sort themselves out.

STATE	PAPER FILING REQUIRED	CD-ROM FILING REQUIRED
California	Yes	Optional
Hawaii	Yes	Optional
Illinois	Yes	Optional
Indiana	No	Yes
Maryland	Yes	Yes
Minnesota	Yes	No
New York	Yes	Optional
North Dakota	Optional	Optional
Rhode Island	No	Yes
South Dakota	No	Yes
Virginia	Yes	No
Washington	Yes	Optional
Wisconsin	Optional	Optional

Lesson Six: Don't Discard Your Notary Stamp

Even though NASAA dispensed with requiring notarized signatures in the revised uniform franchise registration application forms released this spring, several states still insist on notarized signatures, including those that have adopted NASAA's revised application forms. To avoid having an application bounced, take note of the states still requiring notarization, shown below.

STATE	USE NASAA APPLICATION	NOTARIZATION REQUIRED
California	No	Yes – All Forms
Hawaii	Yes	Yes – Only Consent to Service
Illinois	Yes	No
Indiana	Yes	No
Maryland	Yes	No
Minnesota	Yes	Yes – All Forms
New York	No	Yes – All Forms
North Dakota	Yes	No
Rhode Island	Yes	No
South Dakota	Yes	No
Virginia	Yes	Yes – Only Consent to Service
Washington	Yes	No
Wisconsin	Yes	No

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