

Franchise Offerings

If you are interested in forming and filing a franchise for your existing business, there are several important legal issues to consider.

Business Opportunity vs. Franchise

There are two areas of law in this respect, namely, business opportunity and franchise law. "Business opportunity," which is legally known as Seller Assisted Marketing Plans, as defined under California Civil Code §1812.200 and are known as "SAMPs." SAMPs must register with the Attorney General's Office of each state, as required, provide disclosure statements, and provide buyers with specific notice and disclosures. The registration requirements, fees, and notice period are less than for a franchise. The Seller Assisted Marketing Plan Act was written for and aimed at seller discount buyers (think Avon, Jafra, MaryKay, Herblife) and the sale of vending machines, racks or work-at-home paraphernalia.

I recommend that an attorney review your proposed business plan to determine whether or not your proposed business falls within the definition of a franchise. There are also complicated statutory schemes with the SAMP Act that may cause concern regarding how long you have been in business. Your business plan may fall within the registration requirements of a franchise under California law.

As defined with the California Corporations Code §31005, a franchise means, a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which: (1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and(2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and (3) The franchisee is required to pay, directly or indirectly, a franchise fee.

There is a great deal of debate over the definition of a fee and many cases regarding such. The Department of Corporations defined such in its Release 3-F on 6/22/94. Corporations Code §31011 defines the fee very broadly. Any fee or charge which the franchisee is required to pay to the franchisor for the right to engage in business is a franchise fee regardless of the designation given to, or the form of, such payment; in other words, regardless of what you call it by name.

Registration Filing

You will need to file for registration in any state where you make an offer to sell in that state, an offer to buy is accepted in that state, and where you domicile or operate business. You will need to also file for registration in any state that an offer is directed to an offeree of that state. I recommend that an attorney research the Blue Sky laws of each proposed state and register your offering in each state. You may want to pursue under a multi-state filing, especially if you are e-commerce based.

Some of the documents created in the preparation of a franchise filing include:

- *Franchise Registration Information
- *Uniform Franchise Registration Application
- *Supplemental Information
- *Customer Authorization
- *Corporate Acknowledgment
- *Uniform Consent To Service Of Process
- *Sales Agent Disclosure Form
- *Guarantee Of Performance

A sample document index of a franchise offering, and which defines the scope of work in preparing a Uniform Franchise Offering Circular together with the related documents and registration is as follows:

- *Application_Transmittal_Letter.pdf
- *Application_Facing_Page.pdf
- *Certification_Page.pdf
- *Consent_to_Service_of_Process.pdf (required for all except CA corporations)
- *Corporate_Acknowledgement.pdf
- *Supplemental_Information.pdf
- *Sales_Agent_Disclosure_Forms_redacted.pdf
- *Guarantee_of_Performance.pdf (if any)
- *Auditors'_Consent.pdf
- *Franchise_Offering_Circular.pdf
- *Receipt.pdf
- *Exhibit_1_Franchise_Agreement.pdf
- *Exhibit_2_Financial_Statements.pdf
- *Exhibit_3_Area_Development_Agreement.pdf (if any)
- *Exhibit_4_List_of_Administrators.pdf
- *Exhibit_5_Agents_for_Service_of_Process.pdf
- *Exhibit_6_List_of_Franchisees.pdf

*Exhibit 7_List_of_Former_Franchisees.pdf

*Exhibit 8_State_Specific_Appendix.pdf

*Exhibit_Other_Exhibits.pdf

*Customer_Authorization_of_Disclosure_of_Financial_Records.pdf

*Sales_Agent_Disclosure_Forms_un-redacted.pdf

There has been a great deal written on the internet regarding business opportunity law: it is not worth the risk to walk the grey line or area regarding whether or not you can avoid the registration requirements of the Franchise Investment Law. This is especially true if you are looking to be a global presence. You may also start growing large as to disqualify you as an SAMP and then have to file as a franchise. You would then have to incur fees and costs all over again and the SAMP registration would have been a waste of time and money and effort on your part. The fines and penalties for violating various provisions of the Corporations Code and the Franchise Investment Law are significant as indicated below:

Franchise Investment Law Violations

*31405 Violation of Law/Rule/Order Up to \$10,000 Civil Penalty per violation

*31406 Violation of Law/Rule/Order Up to \$2,500 Administrative Penalty per violation

*31410 Willful Violation of Law/Rule/Order Up to \$100,000 or up to 1 year state/county prison or both

*31411 Willful Violation of Law/Rule/Order Up to \$100,000 or up to 1 year state/county prison or both.

This is a situation where shaving costs initially, would lead to a large liability in the future and cause you to be reactive to an investigation which could potentially put you out of business or worse, jail time.

Registration Timing

Once the Uniform Franchise Registration Application is filed with the California Department of Corporations ("DOC"), you are deemed registered within 15 business days after filing if no stop order is issued by the DOC. You will need to give prospective franchisee's the disclosure documents (UFOC) 14 days prior to their signing the contract. Your registration is good for one year and is renewed each year for one year terms. The filing fee to the DOC is \$675.00 and renewal each year is \$450.00. Any amendments are \$50.00.

Capital and Equity

Regarding your capital and equity questions regarding valuation and cash assets, there are financial factors and requirements that the Department of Corporations (“DOC”) looks at. There is set or fixed amount. The DOC requires that financial statements be audited by an independent CPA; a balance sheet within 90 days prior to the application must be submitted; Profit and Loss Statements for each of the 3 years preceding the date of balance sheet, if any. If the 90 day balance sheet is not audited, then you must include a yearend audited from the previous year end.

Your financials must demonstrate adequate financial arrangements that will fulfill the franchisor’s obligation to provide real estate, improvements, equipment, inventory, training or other items in the offering. If you cannot demonstrate such, the DOC will require that any franchise fees paid are placed in an impound trust account (100% of the fees paid and within 48 hours of receipt). This involves a Purchase Receipt filing with the DOC for each one. Funds are only released with DOC approval upon a showing that you have fulfilled the obligations to the franchisee. You may request a surety bond in lieu of an impound. The amount of the bond would equate the aggregate liability to all franchisees within the state.

The DOC may accept a current “review” report balance sheet in lieu of an audit provided several conditions are met. You will need to have a CPA involved with the legal team who can work with me. The bottom line is that your financials must demonstrate present financial ability to meet the obligations stated with the UFOC without relying on proposed franchisee’s funds. In other words, you can’t use franchisee fees as seed monies to raise capital and avoid Private Placement Memorandum requirements. You can avoid an impound, discussed above, by an increase in your capitalization and a Guarantee of Performance coupled with a personal guarantee and submission of your personal financials, or the financials of the guarantor.

Equity Value

You need to have an entity formed as a corporation or LLC that is capitalized sufficiently to meet all franchisor obligations. The equity value of the company will be your capital account, all assets, both tangible and intangible e.g. goodwill, intellectual property registration, less expenses. You will need to have enough money in the entity to meet all the materials, training and equipment that you will provide to franchisees to open their business. You may need to have a discussion with your CPA about how to best achieve this goal.

The Uniform Franchise Registration Application is to be completed and submitted by the corporate entity, not an individual or individual shareholder. The Salesman Disclosure Form required under 10 Cal. Code Reg. §310.210(a)(2), lists all persons who will engage in the offer or sale of the franchises in California. This includes the name, address, employer, titled, SSN, birthday, employment or occupation for the last 5 years (basically your resume); and must disclose all administrative, civil, or criminal pending actions; felony convictions or pleas or civil judgments within last 10 years; and any violations ever with the SEC, franchise laws, securities laws, antitrust laws etc.

Approved Registration

Regarding the timing element of the franchise applications and DOC approval: if there is no stop order issued by the DOC, your registration is effective at noon on the 15th business day after filing the application for registration. You cannot solicit franchises until registration. Remember you must provide prospective franchisees at least ten business days prior to execution of any contract or receipt of monies a copy of the disclosure (UFOC) and copy of proposed agreement relating to the sale of the franchise. This time period changes next year to fourteen days prior to execution, the UFOC must be presented.

Where the franchisor owes directly or indirectly more than 50% of the outstanding voting securities of any other corporation e.g. stock, the financials required to be filed should reflect on a consolidated basis the financial condition of the franchisor and each subsidiary.

Franchise Laws

Many states have franchise laws which may apply to an offer or sale of a franchise. A state franchise law is potentially applicable whenever: (a) the prospective franchisee is a resident of or domiciled in the state; (b) the franchised business is to be located or to operate within the state; (c) the offer to sell originates in the state; or (d) the offer was directed to, or accepted from, the state.

Currently 12 states require annual pre-sale registration of a franchisor's UFOC. Those states are California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin (the "Registration States"). Michigan and Indiana require a Notice of Intent (to sell franchises) to be filed and Michigan also requires state-specific language to be included in an addendum to the offering circular (although the actual addendum need not be filed or registered). In addition to these states' franchise laws, it is

necessary to register or file exemption notices under the business opportunity laws of Florida, Kentucky, Nebraska, Texas and Utah. Although the UFOC attempts to provide a common format to permit franchisors to comply with state franchise disclosure laws, the registration states have adopted laws or regulations that require certain variations to the uniform format. State variations required in registration states result from both published statutes and regulations as well as local practice. These state specific changes are contained in a state specific amendment to the UFOC and franchise agreement. In response to a franchise registration application, state examiners review the UFOC submitted for registration and generate comment letters which identify “deficiencies” which must be satisfied prior to registration.

In 2004, California announced that it would participate in the coordinated review program. Therefore, once the UFOC has been approved and registered by the examining state, it is approved and registered for all of the registration states. The Coordinated Review program is only available for initial franchise registrations and not renewals.

Franchisors must deliver state-specific disclosure documents (that is registered offering circulars along with the state specific addendum) to franchise prospects in that state. Several states have disclosure obligations that are greater than those required by the FTC Rule, such as Illinois, which requires that the UFOC be delivered at least 14 calendar days before: (a) the prospect signs any agreement; or (b) the receipt of any consideration from the prospect.

Advertising Caveat

Just a cautionary note on advertising: All advertising used to promote franchise sales, including promotional material given to prospective franchisees to influence their investment decision, must be filed with state authorities in 9 states before they can be used in those states. These states are: California, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota and Washington.

Franchise advertising includes: (1) franchisee recruitment advertising; (2) any oral communication contained in recorded telephone messages, radio or television advertising or similar communication, made in connection with an offer of a franchise or to induce the purchase of a franchise; and (3) any printed communication including newspaper, brochures, electronic sales presentations, reproduced magazine articles, form solicitation letters and other writings. Typically, all internet advertising must also be filed with the appropriate state authority.

Penalties

A final cautionary word about enforcement and penalties. Please remember that a failure to comply with the disclosure obligations contained in the FTC Rule is a violation of §5 of the Federal Trade Commission Act, 15 U.S.C. §45, and punishable by a fine of \$11,000 for each violation as well as additional liability for any injury to a consumer as a result of the FTC Rule violation.

Similarly, a failure to comply with the disclosure obligations of any registration state may result in administrative actions resulting in civil and criminal penalties and may result in stop orders preventing the franchisor from selling in the state. Further, the failure to comply with the disclosure obligations under state law may subject the franchisor, its officers, directors, employees, salespersons and sales brokers to criminal sanctions as well as franchisee lawsuits for recession of the franchise agreement, attorney's fees and treble damages.

I look forward to working with you as part of your legal team in an effort to truly make this idea of yours a prosperous success. Please contact Tamara L. Harper, Esq. and we would be happy to discuss your specific situation with you.