

# Material Changes and the FDD: Amending and Going Dark

Terrence M. Dunn

Franchisors focus on updating their franchise disclosure document (FDD) on an annual basis. But franchisors may overlook the obligation that exists under the Federal Trade Commission (FTC) Rule<sup>1</sup> and various state statutes and regulations to amend their FDD on a more frequent basis upon the occurrence of a material event or material change.<sup>2</sup> The process and timing of creating and possibly registering such an amendment could require the franchisor to stop making sales or “go dark.” Worse, failing to respond at all or within the time period required can create significant liability for a franchisor.



Mr. Dunn

What circumstances would force a franchisor to go dark and amend its FDD? How quickly do franchisors have to respond to such events? What are the consequences, penalties, and possible remedies of failing to do so? What is the lawyer’s role in monitoring these situations?

It is easy enough to imagine a scenario in which a franchisor presents to its prospective franchisees a newly minted FDD, with registration renewed in several states, containing the requisite current information as well as its audited financial statements. Because of its rapid expansion, the franchisor’s cash flow is tight, and midyear it falls behind on one of its bank loans. Unexpectedly, the bank takes an aggressive posture and notices an event of default that will result in a lawsuit if payment is not made. The franchisor

---

1. 16 C.F.R. § 436 (2007).

2. California Franchise Investment Law, CAL. CORP. CODE §§ 31000 et seq.; Hawaii Franchise Investment Law, HAW. REV. STAT. §§ 482-E1 et seq.; Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. 705/1 et seq.; IND. CODE ANN. §§ 23-2.5-1 et seq.; MD. CODE ANN. BUS. REG. §§ 56-345 et seq.; MINN. STAT. ANN. §§ 80C.01 et seq.; N.Y. GEN. BUS. §§ 680 et seq.; North Dakota Franchise Investment Law, N.D. CENT. CODE ANN. §§ 51-19-01 et seq.; Rhode Island Franchise and Distributorship Investment Regulations Act, R.I. GEN. LAWS ANN. §§ 19-28-1 et seq.; South Dakota Franchises for Brand-Name Goods and Services Law, S.D. CODIFIED LAWS §§ 37-5A-1 et seq.; Virginia Retail Franchising Act, VA. CODE ANN. §§ 13.1-557 et seq.; Washington Franchise Protection Act, WASH. REV. CODE ANN. §§ 19.100.010 et seq.; Wisconsin Franchise Investment Law, WIS. STAT. ANN. §§ 553.01 et seq.

---

---

*Terrence M. Dunn (tmd@ed-lawfirm.com) is a partner in the New York firm of Einbinder & Dunn, LLP. The author would like to thank Richard Bayer, an associate with the firm, for his assistance in researching and preparing this article.*

---

---

enters into feverish negotiations with the bank, hopeful that disaster can be averted, but in the meantime it continues to sell franchises. However, negotiations fall apart, and a lawsuit is initiated. At that point, the franchisor ceases franchise sales and moves to amend its FDD to reflect the lawsuit. However, after learning of the earlier notice of default, franchisees that purchased their respective franchises just prior to the litigation make a demand upon the franchisor to rescind the franchise agreement. The franchisor takes the position that it has the ability to meet its financial obligations and that the sales were made prior to the litigation and refuses to rescind the sales. The franchisees sue and notify the applicable regulatory authorities of the lawsuit. When should the franchisor have ceased sales and gone dark? Should the franchisor have amended its FDD earlier to describe the change of condition? What is the franchisor's exposure?

## **I. Materiality: Statutes, Regulations, and Case Law**

### *A. Statutory and Regulatory Framework*

The FTC Rule<sup>3</sup> and various state statutes and regulations<sup>4</sup> require the franchisor to amend its FDD upon an occurrence, which is described in some cases as a material event and in others as a material change. Although some states, such as Minnesota,<sup>5</sup> reference material event and material change as if they are separate and distinguishable concepts, it appears to the author that the two terms are essentially the same concept. But what is the definition of material?

The FTC Rule<sup>6</sup> does not expressly define the term “material event” or “material change.” However, it provides a definitional framework for the application of the concept of materiality. The 2007 Statement of Basis and Purpose (SBP),<sup>7</sup> in which the FTC provides commentary on the underlying rationale for the disclosure obligations contained in the FTC Rule, notes that the FTC regards a representation, omission, or practice to be material if it is likely to affect consumers' conduct or decisions with respect to the product at issue.<sup>8</sup> Accordingly, “materiality” is determined by the viewpoint of the

3. 16 C.F.R. § 436 (2007).

4. California (CAL. CORP. CODE § 31123 (1971)); Hawaii (HAW. REV. STAT. § 482-E3(b) (West 2014)); Illinois (815 ILL. COMP. STAT. 705/11 (2009)); Indiana (IND. CODE ANN. § 23-2-2.5-10.5 (West 2014)); Maryland (MD. CODE ANN. BUS. REG. § 14-220(a) (2014)); Michigan (MICH. COMP. LAWS ANN. § 445.1519 (West 2014)); Minnesota (MINN. STAT. ANN. § 80C.07 (2000)); New York (N.Y. GEN. BUS. § 683(9)(a) (1981)); North Dakota (N.D. CENT. CODE § 51-19-07.6(a) (1991)); Rhode Island (R.I. GEN. LAWS ANN. § 19-28.1-11 (West 2014)); South Dakota (S.D. CODIFIED LAWS § 37-5B-7(2) (2014)); Washington (WASH. REV. CODE ANN. § 19.100.070(3) (2012)); Wisconsin (WIS. STAT. ANN § 553.31(1) (West 2014)).

5. MINN. R. 2860.2400 (2007)

6. 16 C.F.R. § 436 (2007)

7. Statement of Basis and Purpose, 72 Fed. Reg. 15444 (Mar. 30, 2007).

8. *Id.* at 15455.

reasonable prospective franchisee.”<sup>9</sup> In practice, the materiality of a fact or an omission of a fact will depend on the particulars of the franchisor and the franchise system, including the number of franchises in operation and the operating history and experience of the franchisor, among other factors.

A majority of state franchise registration statutes do not specifically define the term “material change,” instead relying on a definitional framework similar to that of the FTC. For example, Virginia provides that a “material change” includes a fact, circumstance, or condition that would have a substantial likelihood of influencing a reasonable prospective franchisee in the making of a decision relating to purchase of the franchise.<sup>10</sup>

Six registration states have established detailed examples of events that constitute a material change:

Hawaii<sup>11</sup> provides that a material event or material change may include, but not be limited to, the following:

1. the termination, closing, or failure to renew during any three month period of (a) the greater of one percent or five of all franchises of a franchisor or subfranchisor regardless of location or (b) the lesser of fifteen percent or two of the franchises of a franchisor or subfranchisor located in Hawaii [an identical definition is used in Wisconsin<sup>12</sup>];
2. any change in control, corporate name, or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor or subfranchisor is a subsidiary, is required to file reports under section 12 of the Securities Exchange Act of 1934 [an identical definition is used in Wisconsin and similar definitions are used in Maryland and Minnesota<sup>13</sup>];
3. the purchase by the franchisor in excess of five percent of its existing franchises during any three-month period on a continuous basis [an identical definition is used in Wisconsin<sup>14</sup>]; or
4. the commencement of any new product, service, or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuation or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis [an identical definition is used by Wisconsin<sup>15</sup>].

Illinois<sup>16</sup> provides that a change is material if there is a substantial likelihood that a reasonable prospective purchaser would consider it significant in making a decision to purchase or not purchase the franchisee, including, without limitation:

---

9. *Id.* at 15482.

10. VA. ADMIN. CODE § 5-110-10 (2015).

11. HAW. CODE. R. § 16-37-1 (1981).

12. WIS. ADMIN. CODE § 31.01(2)(a) (2008).

13. Maryland (MD. CODE REGS. 02.02.08.01(9)(c),(d) (2015); COMAR 02.02.08.01 (9)(c) (2015), (d)); Minnesota (MINN. R. 2860.2400(B) (2015)); Wisconsin (WIS. ADMIN. CODE § 31.01(2)(b) (2008)).

14. WIS. ADMIN. CODE § 31.01(2)(c) (2008).

15. *Id.*

16. ILL. ADMIN. CODE tit. 14 § 135.353 (2015).

1. any increase or decrease in the initial or continuing fees charged by the seller [a similar definition is used in New York<sup>17</sup>];
2. a change of more than fifteen percent in the number of requests for refund or rescission or other mode of termination or cancellation of business opportunities sold which were received by the seller in the most recent quarter since the effective date of the current disclosure document;
3. a change in the seller's management;
4. a change in the seller's or purchaser's obligations under the contract or agreement of sale or related agreements [as a practice note, it is worth commenting that the third and fourth example here, as some others, are quite broad and may not necessarily be material to a prospective franchisee];
5. a decrease in the seller's income or net worth of more than twenty-five percent; or
6. additional litigation or a significant change in the status of litigation, including, without limitation (a) the filing of a complaint, or amendment thereto, alleging or involving violations of any business opportunity or franchise law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property or breach of contract, (b) the entry of any injunctive or restrictive order relating to any business opportunity; or the entry of any injunction under any federal, state, Canadian or Mexican business opportunity, franchise, securities, anti-trust trade regulation or trade practice law, and (c) the entry of a judgment that has or would have any significant financial impact on the seller. Such a judgment is considered to have a significant financial impact if it equals fifteen percent or more of the current assets of the seller and its subsidiaries on a consolidated basis.

Maryland defines a material change, for purposes of the Maryland Franchise Law,<sup>18</sup> to include, but not be limited to:

1. the termination, in any manner, of more than ten percent of the franchises of the franchisor that are located in the State during any three-month period or the termination, in any manner, of more than five percent of all franchises of the franchisor regardless of location during any three-month period [a similar definition is used in Minnesota<sup>19</sup> and New York<sup>20</sup>];
2. a reorganization of the franchisor or a change in control, corporate name, or state of incorporation of the franchisor;
3. the commencement of any new product, service, or model line requiring, directly or indirectly, additional investment by any franchisee; or
4. the discontinuation or modification of the marketing plan or system of any product or service of the franchisor which accounts for at least twenty percent of the annual gross sales of the franchisor.

Minnesota<sup>21</sup> defines a material event or material change to include, but not be limited to, the following:

1. the termination, closing, or failure to renew by the franchisor during any consecutive three-month period after registration of ten percent of all

17. N.Y. COMP. CODES R. & REGS. tit. 13 § 200.5(b)(3) (1981).

18. MD. CODE REGS. 02.02.08.01(9) (2015); COMAR 02.02.08.01 (9) (2015).

19. MINN. R. 2860.2400(A) (2015).

20. N.Y. COMP. CODES R. & REGS. tit 13 § 200.5(b)(1) (1981).

21. MINN. R. 2860.2400 (2015).

- franchises of the franchisor, regardless of location, or ten percent of the franchises of the franchisor located in the state of Minnesota;
2. any change in control, corporate name, or state of incorporation, or reorganization of the franchisor;
  3. the purchase by the franchisor during any consecutive three-month period after registration of ten percent of its existing franchises, regardless of location, or ten percent of its existing franchises in the state of Minnesota;
  4. the commencement of any new product, service, or model line involving, directly or indirectly, an additional investment in excess of twenty percent of the current average investment made by all franchises or the discontinuation or modification of the marketing plan or marketing system of any product or service of the franchisor where the average total sales from such product or service exceed twenty percent of the average gross sales of the existing franchisees on an annual basis;
  5. any change in the franchise fees charged by the franchisor; or
  6. any significant change in:
    - a. the obligations of the franchisee to purchase items from the franchisor or its designated sources;
    - b. the limitations or restrictions on the goods or services which the franchisee may offer to a customer;
    - c. the obligations to be performed by the franchisor; or
    - d. the franchise contract or agreement, including all amendments thereto.

New York<sup>22</sup> provides that the term material change includes, but is not limited to:

1. the termination, closing, or failure to renew, during a three-month period, of the lesser of ten or ten percent of the franchises of a franchisor, regardless of location;
2. a purchase by the franchisor in excess of five percent of its existing franchises during six consecutive months;
3. a change in the franchise fees charged by the franchisor;
4. any significant adverse change in the business condition of the franchisor or in any of the following: (a) the obligations of the franchisee to purchase items from the franchisor or its designated sources; (b) limitations or restrictions on the goods or services which the franchisee may offer to its customers; (c) the obligations to be performed by the franchisor; (d) the franchise contract or agreements, including amendments thereto; (e) the franchisor's accounting system resulting in a five percent or greater change in its net profit or loss in any six month period; or (f) the service, product, or model line; or
5. the issuance of audited financial statements of a fiscal year subsequent to the one in the FDD.

Wisconsin<sup>23</sup> provides that the material event or material change includes, but is not limited to:

1. the termination, closing or failure to renew during any three-month period of (a) the greater of one percent or five of all franchises of a franchisor regardless of location or (b) the lesser of fifteen percent or two of the franchises of a franchisor located in the state of Wisconsin;

---

22. N.Y. COMP. CODES R. & REGS. tit 13 § 200.5(b) (1981).

23. WIS. ADMIN. CODE § 31.01(2)(a)-(e) (2008).

2. any change in control, corporate name or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor is a subsidiary, is required to file reports under Section 12 of the Securities Exchange Act of 1934;
3. the purchase by the franchisor of in excess of five percent of its existing franchises during any three-month period on a running basis;
4. the commencement of any new product, service or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuation or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis; or
5. an adverse financial development involving the franchisor or the franchisor's parent company, controlling person or guarantor of the franchisor's obligations. The term adverse financial development includes, but is not limited to (a) the filing of a petition under federal or state bankruptcy or receivership laws or (b) a default in payment of principal, interest, or sinking fund installment on indebtedness that exceeds five percent of total assets which is not cured within thirty days of the default.

## B. Case Law

When litigated, the materiality of a fact or omission of a fact generally is determined by using an objective standard of what a reasonable person would consider important in determining whether to purchase a franchise.<sup>24</sup> Case law is scarce in applying amendment requirements in connection with the occurrence of a material event. Except for *Hanley v. Doctors Express Franchising, LLC*, the applicable cases analyze materiality in the context of whether an untrue statement of fact or an omission of fact is material with respect to a franchise offering.

*Hanley* illustrates the nature of information that would require a material amendment, although the only decision on record in this particular case concerned the defendants' motion to dismiss the plaintiffs' claims.<sup>25</sup> Doctors Express sold a franchise for the management of an urgent care medical center. In January 2010, Doctors Express provided the plaintiff with a copy of its then-registered FDD and other materials, which described the initial investment required, the average number of patients treated per day at urgent care medical centers, and the average revenue per patient.<sup>26</sup> The 2009 FDD initial investment information and financial performance representation were prepared in reliance on the experience and data collected from the franchisor's affiliate that operated an urgent care center in Maryland. The court noted that Doctors Express knew that the experience of and data from the Maryland affiliate were materially different from that of its actual franchisees and were not a reasonable basis on which to estimate the initial investment

---

24. See *Morris v. Int'l Yogurt Co.*, 729 P.2d 33 (1986).

25. *Hanley v. Doctors Express Franchising, LLC*, No. ELH-12-795, 2013 WL 690521 (D. Md. Feb. 25, 2013).

26. *Id.* at\* 2.

that a new franchisee would be required to make in 2010. The court observed that when it gave the FDD to the plaintiffs, Doctors Express knew that the expected revenues during the initial months of a franchise's operations were likely to be substantially below those reported in Item 19 of the FDD, because Doctors Express knew that changes to the Medicare enrollment process would mean that a franchisee would not have medical insurance reimbursement contracts in place immediately to pay claims for patient services.<sup>27</sup> Those Medicare enrollment policy changes made it difficult, if not impossible, for a franchisee to replicate the Maryland affiliate's financial experience.<sup>28</sup>

The plaintiffs opened their Doctors Express DRX center on January 15, 2011. The center allegedly did not do well and closed on July 20, 2011.<sup>29</sup> The plaintiffs contended that the 2009 FDD received from Doctors Express and its representatives contained material misrepresentations relating to the estimated initial investment and the expected financial performance due to changes in the law. Doctors Express argued that it was under no duty to update its FDD other than annually, or stated another way, there was no material event that obligated Doctors Express to update its FDD.<sup>30</sup> The court was unconvinced by Doctors Express's argument. Having survived Doctors Express's motion, the plaintiffs were permitted to proceed with their claims for damages and/or rescission under the Maryland Franchise Law.<sup>31</sup> The case suggests that a change in law affecting performance would be a material event necessitating an amendment.

Other cases discuss materiality, although not in the specific context of requiring an amendment. In *Morris v. International Yogurt Co.*, the court determined that it was a material fact that the franchisor's "unique" yogurt mix was not a trade secret, as the franchisor claimed, because it was available for sale by its manufacturer to third party non-franchisees, and that the omission violated the Washington Franchise Investment Protection Act.<sup>32</sup> In *Motor City Bagels, L.L.C. v. American Bagel Co.*,<sup>33</sup> the court determined that information concerning the start-up costs for the franchise was material because it would alter the total mix of information available to the prospective franchisee. Presumably, the emergence of facts such as these during the year would require amending the FDD.

However, in *Harb v. Norrell Corp.*,<sup>34</sup> the court determined that a franchisor was under no duty to disclose what percentage of its franchisees had or had not met their franchise agreement sales quotas because that disclosure

---

27. *Id.*

28. *Id.* at \*4.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Morris*, 729 P.2d at 39.

33. 50 F. Supp. 2d 460 (D. Md. 1999).

34. *Harb v. Norrell Corp.*, Bus. Franchise Guide (CCH) ¶ 10,231 (W.D. Wash. 1993).

was not material. This case suggests that certain aspects of ongoing franchisee financial performance would not cumulatively constitute a material event. These cases are instructive of how courts might define material change if there is no applicable state statute or regulation.

## II. Amendment Requirements and Effect on Sales

### A. *Going Dark*

As noted above, the FTC Rule<sup>35</sup> and various state registration statutes<sup>36</sup> create a continuing obligation for the franchisor to update its FDD to reflect material changes. The following sections will discuss the timing and manner in which the franchisor must update its FDD. However, an issue of immediate concern for franchisors and franchise counsel is the effect of a material change upon the franchisor's sales program. In most registration states, applicable statutes mandate that the franchisor must immediately cease the offer and sale of franchises upon the occurrence of a material event.<sup>37</sup>

Under the FTC Rule, which is silent on the issue of going dark upon the occurrence of a material event, the offer and sale of franchises may technically continue, although it would be advisable that the franchisor immediately cease the offer and sale of franchises, given the possible risks inherent with continuing to sell, as discussed later in the Ramifications of a Material Event section. This "going dark" includes the cessation of sales activities relating to prospective franchisees already in the pipeline and may ultimately affect the franchisor's prospective sales, cash flow, and operations. In states operating under the FTC Rule, it is advisable that the franchisor wait to recommence the offer and sale of franchises until after it has amended its FDD because of the availability of various rights to franchisees under state law, as discussed later.

In registration states, there are varying timing requirements as to when a franchisor may recommence the offer and sale of franchises. In Illinois,

---

35. 16 C.F.R. § 436 (2007).

36. California Franchise Investment Law, CAL. CORP. CODE §§ 31000 et seq.; Hawaii Franchise Investment Law, HAW. REV. STAT. §§ 482-E1 et seq.; Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. 705/1 et seq.; IND. CODE ANN. §§ 23-2.5-1 et seq.; MD. CODE ANN. BUS. REG. §§ 56-345 et seq.; MINN. STAT. ANN. §§ 80C.01 et seq.; N.Y. GEN. BUS. §§ 680 et seq.; North Dakota Franchise Investment Law, N.D. CENT. CODE ANN. §§ 51-19-01 et seq.; Rhode Island Franchise and Distributorship Investment Regulations Act, R.I. GEN. LAWS ANN. §§ 19-28-1 et seq.; South Dakota Franchises for Brand-Name Goods and Services Law, S.D. CODIFIED LAWS §§ 37-5A-1 et seq.; Virginia Retail Franchising Act, VA. CODE ANN. §§ 13.1-557 et seq.; Washington Franchise Protection Act, WASH. REV. CODE ANN. §§ 19.100.010 et seq.; Wisconsin Franchise Investment Law, WIS. STAT. ANN. §§ 553.01 et seq.

37. Hawaii (HAW. REV. STAT. § 482.E(a) (West 2014)); Illinois (815 ILL. COMP. STAT. 705/5; 815 ILL. COMP. STAT. 705/11 (2009)); Maryland (MD. CODE ANN. BUS. REG. § 14-228 (2014)); Minnesota (MINN. STAT. ANN. § 80C.02 (2000)); North Dakota (N.D. CENT. CODE § 51-19-03 (1991)); Rhode Island (R.I. GEN. LAWS ANN. §§ 19-28.1-5 (West 2014)); Washington (WASH. REV. CODE ANN. § 19.100.020 (2012)); Wisconsin (WIS. STAT. ANN. § 553.21 (West 2014)).

Indiana, Virginia, and Wisconsin, the franchisor may offer and sell franchises as soon as the amendment has been filed with each respective registration state.<sup>38</sup> In the remaining registration states, except California and New York, the franchisor may not offer or sell franchises until its amended FDD has become effective.<sup>39</sup> California and New York allow the franchisor to continue offering franchises pending the effectiveness of an amendment. However, the sale may not close in California until the amendment has been approved.<sup>40</sup> Once the FDD has been approved in California, the franchisor must provide the prospective franchisee with a copy of the amended FDD and proceed with the normal sales procedures.<sup>41</sup>

On the other hand, New York permits the closing of a sale provided that the following procedures are satisfied.<sup>42</sup> The franchisor must provide the prospective franchisee with a copy of its then currently registered FDD and notify the prospective franchisee in writing that an amendment is pending.<sup>43</sup> If a sale closes, the franchisor must segregate the funds collected in a separate trust or escrow account for the benefit of the franchisee.<sup>44</sup> After the amendment has been registered, the franchisor must provide the franchisee with a copy of its now registered amended FDD and wait for the ten-business day disclosure period to lapse.<sup>45</sup> At the end of that period, the franchisee has the options of (1) rescinding the franchise agreement it entered into and have its initial franchise fee returned; (2) cancelling the franchise agreement it entered into and sign the new franchise agreement, if it differs; and (3) continuing the franchise relationship under the franchise agreement it entered into.<sup>46</sup> Due to the complications in New York's regulatory scheme, it would be far simpler to forego closing the sale of a franchise while an amendment is pending.

### B. *Timing: When Must the Franchisor Amend its FDD?*

Under the FTC Rule, franchisors must prepare revisions to be attached to the FDD within a reasonable time after the close of each fiscal quarter in which a material change occurred.<sup>47</sup> Additionally, if the material change

---

38. Illinois (815 ILL. COMP. STAT. 705/12 (1988)); Indiana (IND. CODE ANN. § 23-2-2.5-17 (2014)); Virginia (VA. ADMIN. CODE tit. 21 § 5-110-60(2015)); Wisconsin (WIS. STAT. ANN. § 553.31(2) (West 2014)).

39. Hawaii (HAW. REV. STAT. § 482-E3(c) (West 2014)); Maryland (MD. CODE ANN. BUS. REG. § 02.02.08.06 (2015); COMAR 02.02.08.06 (2015)); Minnesota (MINN. STAT. ANN. § 80C.07 (2000)); New York (N.Y. GEN. BUS. § 683(9)(b) (1981)); North Dakota (N.D. CENT. CODE §51-19-07.6(b) (1991)); Rhode Island (R.I. GEN. LAWS ANN. § 19-28.1-9(c)(1) (West 2014)); Washington (WASH. REV. CODE ANN. § 19.100.060 (2012)).

40. CAL. CORP. CODE § 31107 (1971).

41. CAL. CORP. CODE § 31107.

42. N.Y. COMP. CODES R. & REGS. tit 13 § 200.3(i)(2), (3) (1981).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. 16 C.F.R. § 436.7(b) (2007).

relates to an Item 19 financial performance representation, the FTC Rule mandates that “when furnishing a disclosure document, the franchise seller shall notify the prospective franchisee of any material changes that the seller knows or should have known occurred in the information contained in any financial performance representation made in Item 19.”<sup>48</sup> The fact that the FTC Rule specifically sets forth this notification obligation separately from the general obligation to amend within a time period shorter than a reasonable time after the close of the next quarter, implies that material changes to Item 19 financial performance representations are different and more important than other material changes.<sup>49</sup> For that reason, it is also implied that notice of material changes to Item 19 financial performance representations changes must be given to any prospective franchisee sooner rather than within a reasonable time after the close of the following quarter.<sup>50</sup>

Upon the occurrence of a material change, franchise registration states require amendments to be filed, as follows: California (promptly after a material event),<sup>51</sup> Hawaii (before further sales of the franchise are made in Hawaii),<sup>52</sup> Illinois (within thirty days after the close of each quarter of its fiscal year in which a material change occurred),<sup>53</sup> Maryland (promptly),<sup>54</sup> Michigan (promptly),<sup>55</sup> Minnesota (within thirty days after a material change),<sup>56</sup> New York (promptly),<sup>57</sup> North Dakota (promptly),<sup>58</sup> Rhode Island (promptly),<sup>59</sup> Virginia (within thirty days of a material change),<sup>60</sup> Washington (as soon as reasonably possible and before any further sale occurs),<sup>61</sup> and Wisconsin (within thirty days of a material event).<sup>62</sup> South Dakota does not require an amendment to be filed nor does Indiana, unless the commissioner requests additional information.<sup>63</sup> South Dakota has elected to follow the FTC Rule by mandating that the franchisor prepare an amendment to be attached to the disclosure document within a reasonable time after the close of each quarter of the fiscal year.<sup>64</sup> As noted earlier, the franchisor is prohibited from completing franchise sales in California, Hawaii, Illinois, Indiana, Maryland, Minnesota, North Dakota, Rhode Island,

---

48. 16 C.F.R. § 436.7(d) (2007).

49. 16 C.F.R. § 436.7(b), (d) (2007).

50. *Id.*

51. CAL. CORP. CODE § 31123 (1971).

52. HAW. REV. STAT. ANN. § 482-E3(b) (West 2014).

53. 815 ILL. COMP. STAT. 705/11 (2009).

54. MD. CODE ANN. BUS. REG. § 14-220(a) (2014).

55. MICH. COMP. LAWS ANN. § 445.1519 (West 2014).

56. MINN. STAT. ANN. § 80C.07 (2000).

57. N.Y. GEN. BUS. § 683(9)(a) (1981).

58. N.D. CENT. CODE § 51-19-07.6(a) (1991).

59. R.I. GEN. LAWS ANN. § 19-28.1-11 (West 2014).

60. VA. ADMIN. CODE § 5-110-40 (2015).

61. WASH. REV. CODE § 19.100.070(3) (2012).

62. WIS. STAT. ANN. § 553.31(1) (West 2014).

63. IND. CODE ANN. § 23-2-2.5-10.5 (West 2014).

64. S.D. CODIFIED LAWS § 37-5B-7(2) (2014).

South Dakota, Virginia, Washington, and Wisconsin until the franchisor has amended its FDD and the amendment has become effective, as discussed later.<sup>65</sup>

### C. *Effective Date of Amendment*

Under the FTC Rule, the FDD is effective immediately upon its issuance.<sup>66</sup> Accordingly, an FDD amended to reflect a material change will become effective on the date that it is issued by the franchisor. In Illinois, Indiana, Virginia, and Wisconsin, the amendment will be effective immediately upon filing and the franchisor may recommence the offering of franchises for sale in those states after filing.<sup>67</sup> In the following registration states, the amendment will become effective as follows: California (effective upon approval by commissioner), Hawaii (seven days after filing), Maryland (fifteen business days after filing), Minnesota (effective upon issuance of an order by the commissioner), New York (effective upon approval by the department), North Dakota (effective upon approval by the commissioner), Rhode Island (thirty business days after filing), and Washington (fifteen business days after filing).<sup>68</sup> As noted above, in South Dakota, no filing is required. Rather, the amendment is effective upon its issuance by the franchisor.<sup>69</sup> In each case, the franchisor may resume the offer and sale of franchises after the amendment has become effective.

### D. *Manner of Disclosure of Amended FDD*

After the franchisor amends its FDD to reflect the material change, how should the material change be communicated to prospective franchisees? In registration states, after the FDD is filed and/or registered, where required,

---

65. California (CAL. CORP. CODE § 31124 (1971)); Hawaii (HAW. REV. STAT. § 482-E3(c) (West 2014)); Illinois (815 ILL. COMP. STAT. 705/12 (2009)); Indiana (IND. CODE ANN. § 23-2-2.5-17 (West 2014)); Maryland (MD. CODE REGS. 02.02.08.06 (2015); COMAR 02.02.08.06 (2015)); Minnesota (MINN. STAT. ANN. § 80C.07 (2000)); North Dakota (N.D. CENT. CODE § 51-19-07.6(b) (1991)); Rhode Island (R.I. GEN. LAWS ANN. § 19-28.1-9(c)(1) (West 2014)); South Dakota (S.D. CODIFIED LAWS § 37-5B-7(3),(4) (2014)); Virginia (VA. ADMIN. CODE tit. 21§ 5-110-60 (2015)); Washington (WASH. REV. CODE § 19.100.060 (2012)); Wisconsin (WIS. STAT. ANN. § 553.31(2) (West 2014)).

66. See 16 C.F.R. § 436.2(a), which merely mandates that the franchisor provide a prospective franchisee with a copy of the franchisor's current disclosure document before the franchisee signs the franchise agreement or makes a payment to the franchisor. Absent from the FTC Rule is any requirement that the FDD be registered prior to its use.

67. Illinois (815 ILL. COMP. STAT. 705/12 (2009)); Indiana (IND. CODE ANN. § 23-2-2.5-17 (West 2014)); Virginia (VA. ADMIN. CODE tit. 21§ 5-110-60 (2015)); Wisconsin (WIS. STAT. ANN. § 553.31(2) (West 2014)).

68. California (CAL. CORP. CODE § 31124 (1971)); Hawaii (HAW. REV. STAT. ANN. § 482-E3(c) (West 2014)); Maryland (MD. CODE REGS. 02.02.08.06 (2015); COMAR 02.02.08.06 (2015)); Minnesota (MINN. STAT. ANN. § 80C.07 (2000)); New York (N.Y. GEN. BUS. § 683(9)(b) (1981)); North Dakota (N.D. CENT. CODE § 51-19-07.6(b) (1991)); Rhode Island (R.I. GEN. LAWS ANN. § 19-28.1-9(c)(1) (West 2014)); Washington (WASH. REV. CODE § 19.100.060 (2012)).

69. See S.D. CODIFIED LAWS § 37-5B-7(3),(4) (2014), which is similar to the FTC Rule in that it merely mandates when the franchisor is obligated to amend its franchise agreement but does not require the filing of the amendment with South Dakota.

disclosure of the material change is made to prospective franchisees through the provision of the amended FDD.<sup>70</sup> In these states, all required disclosures must be contained within the FDD.<sup>71</sup> On the other hand, the FTC Rule requires the franchisor to prepare revisions to be attached to the disclosure document to reflect any material change to the disclosures included, or required to be included, in the disclosure document.<sup>72</sup> Each prospective franchisee must receive the disclosure document and the revisions attachment.

Additionally, the FTC Rule specifically provides that if the FDD contains an Item 19 financial performance representation and the franchisor knows or should have known that a material change occurred to that information, the franchisor must “notify” the prospective franchisee of the material change. The “notification” requirement obligates the franchisor to inform the prospective franchisee of the material change. Notification may be accomplished outside of the disclosure document. The manner in which the franchisor “notifies” a prospective franchisee is within the sound discretion of the franchisor. Notification can be made in writing, or by telephone call, e-mail, or other electronic transmission, provided that the franchisor can prove that it has informed the prospective franchisee about the material change.<sup>73</sup> Although Section 436.7 of the FTC Rule<sup>74</sup> does not provide a specific time frame for when such notification must be given, notification must be provided to the franchisee prior to the sale of the franchise in accordance with Section 436.2 of the FTC Rule,<sup>75</sup> otherwise material information will have been omitted from the FDD. For those prospective franchisees receiving an FDD after a reasonable period of time after the close of the quarter following the material change, that FDD should contain the necessary revisions to reflect the material change.<sup>76</sup>

---

70. California (CAL. CORP. CODE § 31119 (1971)); Hawaii (HAW. REV. STAT. § 482.E (b)(West 2014)); Illinois (815 ILL. COMP. STAT. 705/5 (2009)); Indiana (IND. CODE ANN. § 23-2-2.5-9 (West 2014)); Maryland (MD. CODE ANN. BUS. REG. § 14-223 (2014)); Minnesota (MINN. STAT. ANN. § 80C.06 (2000)); New York (N.Y. GEN. BUS. § 683(8) (1981)); North Dakota (N.D. CENT. CODE § 51-19-08 (1991)); Rhode Island (R.I. GEN. LAWS ANN. § 19-28.1-8 (West 2014)); Washington (WASH. REV. CODE § 19.100.080 (2012)); Wisconsin (WIS. STAT. ANN § 553.27 (West 2014)).

71. California (CAL. CORP. CODE § 31114 (1971)); Hawaii (HAW. REV. STAT. § 482.E(a) (West 2014)); Illinois (815 ILL. COMP. STAT. 705/5 (2009)); Indiana (IND. CODE ANN. § 23-2-2.5-13 (West 2014)); Maryland (MD. CODE ANN. BUS. REG. § 14-216 (2014)); Minnesota (MINN. STAT. ANN. § 80C.06 (2000)); New York (N.Y. GEN. BUS. § 683(2) (1981)); North Dakota (N.D. CENT. CODE §§ 51-19-06, 51-19-08 (1991)); Washington (WASH. REV. CODE § 19.100.040 (2012)); Wisconsin (WIS. STAT. ANN. § 553.27 (West 2014)).

72. 16 C.F.R. § 436.7(b) (2007).

73. 16 C.F.R. § 436.7(d) (2007).

74. *Id.*

75. 16 C.F.R. § 436.2 (2007).

76. 16 C.F.R. § 436.7(b) (2007).

### III. Ramifications of A Material Change

#### A. Damages and Rescission Available to Franchisees

A franchisor's failure to amend its FDD to reflect a material change and its continued offering and selling of franchises exposes the franchisor to potential franchisee claims as well as civil and criminal penalties. Although the FTC Rule does not provide franchisees with a private right of action, various states have enacted Little FTC Acts or business opportunity statutes, which typically provide franchisees with the private right to sue for damages and rescission based on unfair or deceptive practices conducted by the franchisor.<sup>77</sup>

In California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, and Washington, franchisees have in varying degrees an independent private right of action against the franchisor either (1) for a franchisor's failure to amend its FDD for a material change and if required, file an amendment reflecting the material change within the time frame and in the manner required by such statute; or (2) for a violation of the statute's antifraud provision.<sup>78</sup>

For example, the Illinois Franchise Disclosure Act of 1987 expressly provides that any person who offers or sells a franchise in violation of the Act shall be liable to the franchisee, which may sue.<sup>79</sup> In Indiana, which does not create a private right of action for violation of disclosure provisions,

77. Arkansas (Franchise Practices Act, ARK. CODE ANN. § 4-72-207)); Connecticut (Business Opportunity Investment Act, CONN. GEN. STAT. ANN. §§ 36b-60 to 36b-80)); Florida (Franchises and Distributorships, FLA. STAT. ANN. § 817.416; Sale of Business Opportunities Act, FLA. STAT. ANN. §§ 559.80 to 559.815)); Georgia (Business Opportunity Sales, GA. CODE ANN. §§ 10-1-410 to 10-1-417)); Iowa (Business Opportunity Promotions Law, IOWA CODE ANN. §§ 523B.1 to 523B.13)); Kentucky (Sale of Business Opportunities Law, KY. REV. STAT. ANN. §§ 367.801 to 367.819, 367.990)); Louisiana (Business Opportunity Sellers and Agents, LA. REV. STAT. ANN. §§ 51:1801 to 51:804)); Maine (Sale of Business Opportunities, ME. REV. STAT. ANN. tit. 32 §§ 4691 to 4700-B)); Mississippi (MISS. CODE ANN. § 75-24-55)); Nebraska (Seller-Assisted Marketing Plan Act, NEB. REV. STAT. ANN. §§ 59-1701 to 59-1761)); New Hampshire (Distributorship Disclosure Act, N.H. REV. STAT. ANN. §§ 358-E:1 to 358-E:8)); North Carolina (Business Opportunity Sales Law, N.C. GEN. STAT. ANN. §§ 66-94 to 66-100)); Ohio (Business Opportunity Purchasers Protection Act, OHIO CODE ANN. §§ 1334.01 to 1334.15, 1334.99)); Oklahoma (Business Opportunity Sales Act, OKLA. STAT. ANN. tit. 71, §§ 801 to 828)); South Carolina (Business Opportunity Sales Act, S.C. CODE ANN. §§ 39-57-10 to 39-57-80)); Tennessee (Little FTC Act, TENN. CODE ANN. §§ 47-18-101 to 47-18-117)); Texas (Business Opportunity Act, TEX. BUS. & COM. CODE ANN. §§ 41.001 to 41.303)); Utah (Little FTC Act, UTAH CODE ANN. §§ 13-11-1 to 13-11-23; Business Opportunity Disclosure Act, UTAH CODE ANN. §§ 13-15-1 to 13-15-6)); Washington, D.C. (Little FTC Act, D.C. CODE ANN. §§ 28-3901 to 28-3908)).

78. California (CAL. CORP. CODE § 31200 (1971)); Hawaii (HAW. REV. STAT. § 482-E9(b) (West 2014)); Illinois (815 ILL. COMP. STAT. 705/26, 705/5(4) (2009)); Maryland (MD. CODE ANN. BUS. REG. §§ 14-227(a)(1), 14-232(a) (2014)); Minnesota (MINN. STAT. ANN. § 80C.17 (2000)); New York (N.Y. GEN. BUS. §§ 683(9)(a), 687(3) (1981)); North Dakota (N.D. CENT. CODE § 51-19-11(1) (1991)); Rhode Island (R.I. GEN. LAWS ANN. §§ 19-28.1-17(7) (West 2014)); South Dakota (S.D. CODIFIED LAWS § 37-5B-7 (2014)); Washington (WASH. REV. CODE § 19.100.190 (2012)).

79. 815 ILL. COMP. STAT. 705/26 (2009).

franchisees are afforded a private right of action for acts that constitute fraud, deceit, or misrepresentation.<sup>80</sup> Thus, franchisees that were sold a franchise in violation of the franchisor's obligations to amend its FDD for a material change may allege a claim under the antifraud section of the Indiana Franchise Act on the theory that the franchisee was sold a franchise through the use of a disclosure document that contained untrue statements of material facts.<sup>81</sup>

In Virginia, the civil remedies afforded by the Virginia Retail Franchising Act (VRFA) provide for a private right of action for presale activities in only limited circumstances, i.e., the right to void the franchise agreement within seventy-two hours after discovery of the franchisor's unlawful sale of the franchise, but in no event more than ninety days after execution of the franchise agreement.<sup>82</sup> In cases where the misrepresentation of a material fact or an omission of a material fact is discovered after the ninety-day period, the franchisee must base its claim on other legal theories when recourse under the VRFA is unavailable.<sup>83</sup> In *Bans Pasta, LLC v. Mirko Franchising, LLC*,<sup>84</sup> a Mirko franchisee brought an action against the franchisor in which it alleged that the franchisor violated the VRFA by making presale misrepresentations concerning the expected financial performance of the franchise. The court, noting that the franchisee's demand to void the franchise agreement was made after the ninety-day period lapsed, dismissed the plaintiff's claims under the VRFA.<sup>85</sup> However, the court held that the plaintiff's claims for fraud in the inducement, constructive fraud, and negligent misrepresentation survived the franchisor's motion to dismiss.<sup>86</sup>

In California, Hawaii, Illinois, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Washington, and Wisconsin, a franchisor that offers or sells a franchise without amending the FDD, as required, in violation of such statute shall be liable to the franchisee for damages and in some cases, rescission.<sup>87</sup> The California and Hawaii statutes specifically provide that rescission is available if the violation is willful, unless (1) the defendant proves that the plaintiff knew the facts concerning the untruth or omission; or (2) the defendant exercised reasonable care and did not know, or, if the defendant exercised reasonable care, would not have known, of

---

80. *Hardee's of Maumelle, Ark, Inc. v. Hardee's Food Sys., Inc.*, 31 F.3d 573 (7th Cir. 1994).

81. *Id.*; Indiana (IND. CODE ANN. § 23-2-2.5-27 (West 2014)).

82. VA. CODE ANN. §§ 13.1-565, 13.1-571 (West 2009).

83. *Bans Pasta, LLC v. Mirko Franchising, LLC*, No. 7:13-cv-00360-JCT, 2014 WL 637762 (W.D. Va. 2014)

84. *Id.*

85. *Id.* at \*7.

86. *Id.* at \*11.

87. California (CAL. CORP. CODE § 31300 (1971)); Hawaii (HAW. REV. STAT. § 482E-9(b) (West 2014)); Illinois (815 ILL. COMP. STAT. 705/26 (2009)); Minnesota (MINN. STAT. § 80C.17 (2000)); New York (N.Y. GEN. BUS. § 691 (1981)); North Dakota (N.D. CENT. CODE § 51-19-12 (1991)); Rhode Island (R.I. GEN. LAWS ANN. § 19-28.1-21 (West 2014)); South Dakota (S.D. CODIFIED LAWS § 37-5B-49 (2014)); Washington (WASH. REV. CODE ANN. § 19.100.190 (2012)); Wisconsin (WIS. STAT. ANN. § 553.51 (West 2014)).

the untruth or omission.<sup>88</sup> For illustrative purposes, a violation is willful in California if the act that constitutes the violation was committed knowingly and intentionally, regardless of whether the defendant acted reasonably or in good faith or was ignorant as to whether the law was violated. In *Dollar Systems, Inc. v. Avcar Leasing Systems, Inc.*,<sup>89</sup> at the time of the franchise sale, Dollar Systems was neither registered in California nor exempt from the California registration requirements.<sup>90</sup> The disclosure document provided to franchisees failed to disclose that the franchisor's principals were subject to a California desist and refrain order that prohibited them from offering or selling franchises in California and failed to disclose the existence of five civil actions involving the franchisor and two criminal convictions for unlawful franchise sale activity.<sup>91</sup> The Ninth Circuit upheld the district court's grant of rescission and the district court's finding that the franchisor's violations were "willful" under the California Franchise Investment Act.<sup>92</sup> Dollar Systems' violations were determined to be willful because, as the district court noted, Dollar Systems knew it had not registered or filed for an exemption and it knew that it failed to make the required disclosures, even though it was not specifically aware of the laws which it violated in the process.<sup>93</sup>

Rescission as a remedy under Virginia law was discussed in the previously cited *Motor City Bagels*.<sup>94</sup> There, the franchisees' claims survived a summary judgment motion, when the court held that the franchisees asserted triable claims of common law fraud and violation of statutory franchise disclosure requirements against a franchisor where there was evidence that the franchisor knew or should have known of information omitted from the FDD that rendered the initial investment cost projections inaccurate and unreliable.<sup>95</sup> The plaintiffs' case in *Motor City Bagels* was buttressed by the fact that a later version of the franchisor's FDD (at that time called a Uniform Franchise Offer Circular, or UFOC), which allegedly was not provided to the franchisees, contained projections significantly different from those in the older UFOC that was provided, and the franchisor knew or should have known the information contained in the later UFOC at the time the franchise agreement was executed.<sup>96</sup> A comparison of the initial investment costs reported in the older UFOC with the initial investment costs disclosed in the more recent UFOC showed an increase in initial investment costs of nearly 20 percent at the low end and 23 percent at the high end.<sup>97</sup> At that phase of the

---

88. California (CAL. CORP. CODE § 31300 (1971)); Hawaii (HAW. REV. STAT. § 482E-9(b) (West 2014)).

89. 890 F.2d 165 (9th Cir. 1989).

90. *Id.* at 168.

91. *Id.*

92. *Id.* at 176.

93. *Id.* at 172.

94. *Motor City Bagels, L.L.C. v. Am. Bagel Co.*, 50 F. Supp. 2d 460 (D. Md. 1999).

95. *Id.* at 489.

96. *Id.* at 469.

97. *Id.* at 470.

action, the court was satisfied that the plaintiffs could demonstrate that they were harmed by reliance on the defendants' misrepresentations as they arguably would not have entered into the various contractual obligations with American Bagel had the defendants disclosed the higher initial investment cost estimates and that the plaintiffs could argue that their reliance was reasonable as the franchisors disclosed this information to aid potential franchisees to assess the merits of the business opportunity.<sup>98</sup> The court ruled that the franchisee retained the right to rescind the franchise agreement if it could ultimately prove its case against the franchisor.<sup>99</sup>

### B. *Administrative Remedies: Imposition of Civil and Criminal Penalties*

The FTC is empowered to prevent unfair and deceptive practices.<sup>100</sup> If the FTC determines that a franchisor has engaged in unfair or deceptive practices, it has broad latitude in determining the appropriate penalties, which include the issuance of cease and desist orders and the imposition of monetary penalties. In *Federal Trade Commission v. Minuteman Press*,<sup>101</sup> the court held that the defendants' gross sales misrepresentations and profit misrepresentations violated Section 5(a) of the FTC Act, because such misrepresentations were likely to mislead customers as to a material fact—the economic viability of the franchise. Further, the court determined that a permanent injunction was necessary to prevent a recurrence of the widespread financial misrepresentations and that monetary relief was warranted to redress injuries suffered by the franchisees.<sup>102</sup>

A franchisor must be cognizant that selling a franchise in a registration state without first amending its FDD to reflect the material change, filing the amended FDD for registration, if required, and disclosing the amended FDD to a prospective franchisee, under the state's requirements, may subject it to civil and criminal penalties. The statutes of each registration state afford significant powers to their respective regulatory agencies, which typically include the ability to seek injunctive relief as well as to impose civil and criminal penalties.<sup>103</sup>

---

98. *Id.*

99. *Id.* at 489.

100. 15 U.S.C. § 45.

101. *Federal Trade Comm'n v. Minuteman Press*, 53 F. Supp. 2d 248, 258 (E.D.N.Y. 1998).

102. *Id.* at 261, 263.

103. California (CAL. CORP. CODE §§ 31404 to 31412 (1971)); Hawaii (HAW. REV. STAT. ANN. §§ 482E-8 to 482E-10.7 (West 2014)); Illinois (815 ILL. COMP. STAT. 705/23 to 705/28 (2009)); Indiana (IND. CODE ANN. §§ 23-2-2.5-28 to 23-2-2.5-41 (West 2014)); Maryland (MD. CODE ANN. BUS. REG. §§ 14-208 to 14-213; §§ 14-227 to 14-232 (2014)); Minnesota (MINN. STAT. ANN. § 80C.16 (2000)); New York (N.Y. GEN. BUS. §§ 688 to 693 (1981)); North Dakota (N.D. CENT. CODE §§ 51-19-13 to 51-19-14 (1991)); Rhode Island (R.I. GEN. LAWS ANN. §§ 19-28.1-18 to 19-28.1.26 (West 2014)); South Dakota (S.D. CODIFIED LAWS §§ 37-5b-24 to 37-5b-48 (2014)); Virginia (VA. CODE ANN. §§ 13.1-567 to 13.1-571 (West 2009)); Washington (WASH. REV. CODE § 19.100.210 (2012)); Wisconsin (WIS. STAT. ANN. §§ 553.52 to 553.54 (West 2014)).

Violators of New York's Franchise Sales Act or Washington's Franchise Investment Protection Act may be offered the opportunity to enter into an assurance of discontinuance. In Maryland, violators of the Franchise Registration and Disclosure Law<sup>104</sup> may be offered the opportunity to enter into a consent order. In the author's experience, the assurance of discontinuance and consent order are essentially settlement agreements between the franchisor and the applicable regulatory agency, which impose monetary penalties on the franchisor and require the franchisor to offer rescission to franchisees to whom the franchisor sold franchises in violation of the applicable state statute or regulation.

The format of an assurance of discontinuance and consent order is typically laid out in the following manner: (1) an introductory section identifying how the regulatory agency came to learn of the franchisor's violations of the applicable statute or regulation, (2) a recitation of the history of the franchisor's FDD registration and franchise sales within the applicable state, (3) a summary of the franchisor's violations of the applicable statute or regulation, (4) a promise by the franchisor to refrain from violating the applicable statute or regulation in the future, (5) a requirement that the franchisor offer rescission for franchises sold in violation of the applicable statute or regulation, and (6) the monetary penalties imposed on the franchisor by the regulatory agency.<sup>105</sup> Although assurances of discontinuance are not made readily available in New York, it may be possible to obtain one through a Freedom of Information Law request. In Maryland, consent orders are available at the Maryland Attorney General's website.<sup>106</sup>

In Virginia, EWC Franchise Group, Inc. sold a franchise after it became insolvent without first amending its FDD and filing that FDD with Virginia.<sup>107</sup> There, the State Corporation Commission's Division of Securities and Retail Franchising conducted an investigation of the franchisor and determined that the franchisor violated the Commission's Retail Franchising Act Rules when it failed to amend its FDD to disclose the insolvency.<sup>108</sup> The Commission entered into a settlement order with the franchisor, in which it assessed monetary penalties against the franchisor in the amount of \$10,000, required the franchisor to remit payment of \$3,000 for the Commission's legal fees, and required the franchisor to promise not to violate the Virginia Retail Franchising Act in the future.<sup>109</sup>

---

104. MD. CODE ANN. BUS. REG. §§ 14-201 to 14-233 (2014).

105. Based upon a client's settlement.

106. Office of the Maryland Attorney General, Consent Orders, [http://www.oag.state.md.us/ZOOMsearch.asp?zoom\\_sort=0&zoom\\_query=Consent+Orders&zoom\\_per\\_page=10&zoom\\_and=0](http://www.oag.state.md.us/ZOOMsearch.asp?zoom_sort=0&zoom_query=Consent+Orders&zoom_per_page=10&zoom_and=0).

107. Commonwealth of Va. *ex rel.* State Corp. Comm'n v. EWC Franchise Grp., Inc., Case No. SEC-2013000006, 2013 WL 1512532 (Va. Corp. Comm'n Apr. 9, 2013).

108. *Id.* at \*1; see VA. ADMIN. CODE tit. 21, § 5-110-40 (2015).

109. *EWC Franchise Grp.*, 2013 WL 1512532, at \*2.

#### IV. Practical Advice for Attorneys

We began this article by presenting a rapidly developing scenario in which a typical franchise company could conceivably find itself. Was the receipt of a notice of default from the bank a material event or a material change? The litigation certainly was, but what of the sale made after the notice from the bank but before the litigation? Would it matter if the company's executives thought in good faith they could settle with the bank? When should they have ceased sales? How could that decision be made in the manner best suited to protect the company?

As noted earlier, the dry statutory and regulatory requirements of what does and does not constitute a material change leave an enormous gray area of events that may or may not meet that definition. In a typical franchise sales company operating in real time, FDDs are being distributed and franchise agreements are being signed all while management or executive-level personnel are evaluating urgent situations and trying to resolve what to do about them. In the meantime, who is evaluating the effect these circumstances should be having on the sales process and the current state of the FDD?

There is not necessarily a bright line of what is and is not material, but there may be little time to make that determination in order to make a decision to go dark before a possibly affected sale takes place. A diligent franchisor counsel would, given the time and resources, set up a mechanism through which ongoing events can be identified and evaluated by knowledgeable personnel for their adverse and potentially material affect.

A franchisor's counsel could consider doing the following:

- Educate the franchisor's management as to what may be considered to be a material event so that the legal department or outside counsel can be notified as such events occur. In addition to those examples specifically set forth by the various registration states, franchisors and their counsel should consider any event, fact, or circumstance that might influence a prospective franchisee's decision to purchase the franchise to be a material change;
- Assist the franchisor with formulating a plan or procedure to address what happens when something that can be identified as a potential material event occurs. The franchisor could circulate a manual and questionnaires to various personnel on a periodic basis for their review concerning the accuracy of the information contained in the FDD;
- Advise the franchisor to have in place periodic auditing and/or monitoring systems of the information contained in the FDD;
- In advance of a material change, identify the specific franchisor's status legally in terms of what laws will govern their franchise sales practices and how they will be required to react. Identify what rules apply to a particular franchisor, either under the FTC Rule, registration states

and/or other states. The key is to identify what effect the material event will have on the franchisor's sales given the location of its sales activities and if an amendment is necessary, where it must be filed and/or registered and when will it be effective;

- Prepare executives to participate with counsel immediately to determine if there is a change that requires the FDD to be updated; evaluate quickly on materiality versus non-materiality;
- Cease sales immediately upon the occurrence of a material event; and
- Establish procedures to communicate with sales personnel concerning when sales may resume. There will be different requirements in different jurisdictions. For a national franchisor, the instructions will have to be geographically specific to avoid running afoul of local requirements.

