

Suspending Franchise Sales

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In several states that require franchise registration, franchisors should suspend franchise sales while an amendment or renewal application is pending with the state. Franchisors commonly suspend franchise sales pending registration in most states that require franchise registration. But California and New York each offers a unique and very different approach than a blackout or suspension of sales.

California takes an approach that is eminently practical. In California, a franchisor may deliver to a prospect the franchise disclosure document ("FDD") as filed with state for renewal or amendment together with a written statement that the filing has been made but it has not been reviewed by the examiner and is not effective, and that the franchisor will deliver to the prospect an effective FDD showing any further revisions at least 14 days before any agreement is signed or any consideration is paid. (Cal. Corp. Code §31107.) This approach seems to be one that would not be objectionable in any registration state even if it is not part of the laws of the other state. How could anyone object to a disclosure of filed materials while the actual sale is being suspended until the registration is effective and the franchisor makes a new disclosure after the amendment or renewal is effective and waits the required 14 days?

New York also does not require franchisors to completely stop all sales while an amendment to the franchise registration is pending. But New York's approach is impractical, leading franchisors generally to suspend sales during the time that an amendment is pending.

In New York, after a material event occurs or an amendment is submitted to the Attorney General's Office and is awaiting review and registration, a franchisor may deliver its registered FDD (not the one that is pending) to a prospective franchisee and notify the prospect in writing that an amendment application is (or is about to be) pending and that the franchisor will deliver to the prospect a copy of the amended FDD when it has been accepted for registration. The franchisor can close the sale while the amendment is pending, but the franchisor must hold any funds paid in trust in a separate bank account until ten business days following the date the prospect receives the registered amended FDD. The new franchisee has the right to rescind the sale at any time up to the end of that ten business day period. If that happens, the franchisor must promptly refund the money held in trust. (NYCRR, Title 13, Chapter VII, Section 200.3(i)(3).)

Few if any franchisors will want to close the sale while the amendment is pending and thereby run the risk of rescission. Also, because the prescribed procedure calls for the use of the registered FDD and not the revised version that is pending approval, the franchisor will not be able to use the latest version of a revised franchise agreement or to disclose new material information until after the franchise sale has taken place.

Incidentally, New York makes no distinction between an amendment and an annual update to a franchise registration. The annual update is also an "amendment".

Also unlike other states, New York views its franchise requirements expansively, so that franchisors based in New York must comply with the New York franchise laws even when they sell franchises outside the state. A New York based franchisor should suspend franchise sales everywhere, even in nonregistration states, whenever an amendment to its franchise registration is pending in New York. On the other hand, if the franchisor is based outside of New York, the suspension required in New York only applies to sales to prospective franchisees in New York.

Franchisors based in states other than New York and selling to prospective franchisees in nonregistration states may use a revised FDD as soon as it is completed. But when selling to prospective franchisees in most registration states, the franchisor should stop selling franchises as soon as a renewal or amendment is filed. Franchise sales can resume after the renewal or amendment is effective in those states.

But when an event occurs that might affect a prospective buyer's decision to purchase the franchise, it may be advisable to suspend sales even before the FDD has been revised and submitted to any states. Upon the occurrence of such a material event, most registration states require a prompt amendment filing and a suspension of sales until the amended FDD is registered. In states that do not regulate franchise sales, it is a good idea to suspend sales between the time that a material event occurs and the time that the revised FDD is completed.

In states that do not require franchise registration, franchise sales are governed only by the Federal Trade Commission's trade regulation rule on franchising (the "FTC Rule"). The FTC Rule requires the franchisor to prepare an updated FDD within 120 days after the end of the franchisor's fiscal year. The FTC Rule also requires quarterly updates of the FDD whenever there is a material change to the disclosures in the FDD.

Even though the FTC Rule does not require a franchisor to suspend sales upon the occurrence of a material event, it may nevertheless be a good idea to do so. The sale of a franchise when the franchisor knows of a material event but has not disclosed it can give rise to a claim of misrepresentation or fraud under state laws.

Franchisor management should be sensitive to the need to amend the FDD. Someone in the organization should be familiar with the contents of the FDD and also be tuned into the most sensitive developments within the company. If a merger or buyout of the company is planned, or if a bankruptcy event or dispute or other threat begins to materialize and is not yet public, the franchisor may not be ready to amend the FDD. But at some point, it may be advisable to suspend franchise sales until the announcement is made and the FDD is amended.