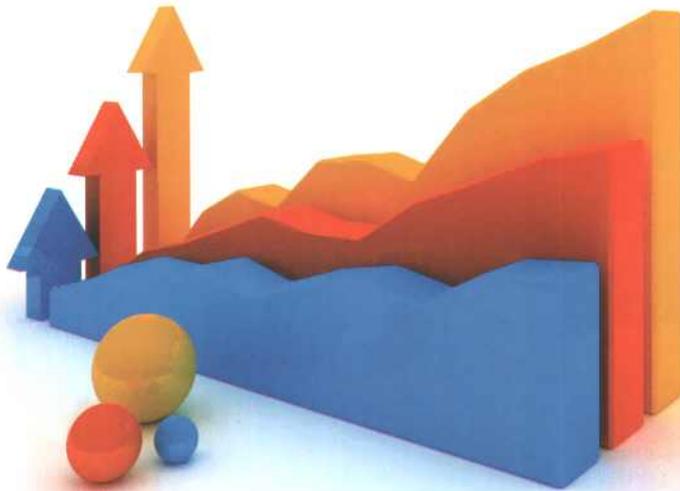


# Size and Experience Matter: Exemptions From Franchise Registration and Disclosure Requirements

Under the right conditions, taking advantage of size and experience exemptions can save a franchisor both time and expense when selling franchises.

BY REGINA B. AMOLSCH AND MICHAEL R. LAIDHOLD

**SAMPLE**



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**B**eing a large and experienced franchisor or doing business with a large or sophisticated franchisee can have its advantages. In some cases, this size translates into the availability of certain exemptions from federal and state franchise disclosure or registration laws. These exemptions may allow franchisors to dispense with preparing and providing disclosure and filing and registering disclosure documents in some franchise registration states.

Other varieties of exemptions are also available under federal and state law (e.g., “fractional franchise” exemptions, exemptions for sales to existing franchisees, and out-of-state sales exemptions). While these other exemptions may also apply to a particular transaction, this discussion focuses on exemptions relating to the size or experience of the franchisor or franchisee. Several franchise registration states also permit their administrators to grant “discretionary” exemptions on a case-by-case basis. And although state discretionary exemptions are also often granted in light of a particular franchisor’s or franchisee’s size and experience or sophistication, they tend to be granted in a more subjective, non-uniform manner.

Despite the availability of certain size and experience exemptions (and perhaps other exemptions), it would be difficult for a franchisor to base its entire franchise sales program on exemptions. While a particular transaction may be exempt under federal law (FTC Rule), it may not

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be available in an applicable state, and vice versa. Also, a transaction may be exempt from applicable state registration requirements but not disclosure requirements. Exemption-based franchising thus has many moving, and potentially inconsistent, parts. But in some cases, a thoughtful knowledge of available exemptions can help save a franchisor time and expense with a franchise sale if exemption conditions can be met.

### Exemptions Based on Franchisor's Size/Experience

Certain state franchise laws (but not the FTC Rule) provide exemptions in recognition of a franchisor's operational experience and financial strength. This type of exemption is known by various names—including the "experienced franchisor," "seasoned franchisor," "large franchisor," and "high net worth franchisor" exemption. Regardless of the name used, these exemptions are based entirely on the characteristics of the franchisor. The rationale is that franchisors with these qualifications have not historically been responsible for severe franchise sales violations and will have the financial resources and permanence to be held accountable if a sales violation is later alleged. California,

Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, Washington and Virginia offer this type of exemption.

**Criteria:** To qualify for a large franchisor exemption, the franchisor (or its parent) must meet certain minimum net-worth and experience requirements. For exemption purposes, a parent is generally defined as a company that owns at least 80 percent of the franchisor.

**Net worth:** The requirement varies significantly from state to state—\$5 million in California, Illinois, Indiana, New York, Washington; \$10 million in Maryland, North Dakota, Rhode Island; and \$15 million in Virginia (and Illinois and New York also have a \$15 million "super large" franchisor exemption). Net worth must be evidenced by audited financial statements. The exemptions also permit a franchisor to rely on its parent's financial statements—so long as the franchisor has a minimum net worth of \$1 million (\$3 million is required for New York's super large exemption). And in some circumstances, if the franchisor relies upon its parent's audited financials, the parent must unconditionally guarantee the franchisor's obligations to its franchisees.

**Experience:** Each state (other than New York and Illinois for its super-

large franchisor exemption) includes a minimum experience requirement for its large franchisor exemption. A franchisor must have a minimum number of years of experience with the business being offered as a franchise, although some states permit a franchisor to rely on its parent's experience. The experience requirement varies from state to state, often requiring the franchisor to have at least 25 franchised units in operation during the previous five years, although some states permit the franchisor's (or its parents') operations to satisfy some or all of the required experience during the relevant period.

**Exemption Process:** Franchisors must take affirmative steps before making an offer or sale of a franchise to claim and rely upon the exemption. Assuming that a franchisor satisfies the exemption criteria, the state statutes (with limited exceptions) require the franchisor apply annually for the exemption by filing certain forms and materials and paying a fee—which is typically less than a registration filing fee. But the exemption filing process should not dissuade a qualified and otherwise interested franchisor, because the exemption approval process is typically faster and less expensive than the franchise registration process. State franchise administrators will review exemption applications along with the franchisor's financial statements (and in some instances portions of the disclosure document), but this review is limited to verifying that the franchisor satisfies the exemption criteria. Considering that registration filings in certain states may be lengthy or difficult, exemptions present opportunities to save substantial time and money in the franchisor's legal compliance activities.

While "large franchisor" exemptions may offer considerable benefits, keep in mind certain limitations apply. As noted above, the FTC Rule does not provide a similar exemption, so disclosure will be required under the FTC Rule even if a state exemption is available. Even when a franchisor qualifies for a state large franchisor exemption, state law still requires pre-sale disclosures, but the state required disclosures may be less extensive (especially so under New York's super large exemption). Franchisors must also monitor their financial condition, as an exemption may become unavailable if there's a drop in the net worth of the franchisor (or its parent).

### Exemptions Based on Prospective

## Franchisees' Size/Experience/Sophistication

Certain states and the FTC also recognize that larger and sophisticated franchisees are not the types of entities that their pre-sale franchise disclosure and/or registration laws are designed to protect. Historically, such exemptions were limited to the states—the FTC did not exempt transactions with such franchisees from federal disclosure requirements. From a practical standpoint, this meant that franchisors contemplating a transaction with a large or sophisticated franchisee, which may have been exempt (from registration and possibly disclosure requirements) under applicable state law, were nevertheless required to provide disclosure under the FTC Rule.

Under the amended FTC Rule (effective in 2007), however, the FTC created two new exemptions applicable to large and sophisticated franchisees: a “large franchisee” exemption and a “large investment” exemption. The large franchisee exemption can be used to exempt from the disclosure requirements of the FTC Rule transactions with franchisees of a certain net worth and experience. Specifically, for a sale to qualify for this exemption, the franchisee must have been

in business for at least five years and have a net worth of at least \$5 million. Business experience may be aggregated from parent and affiliate entities to meet the five-year requirement. Additionally, the franchisee’s “business experience” does not necessarily have to be in the line of business that is the subject of the offered franchise.

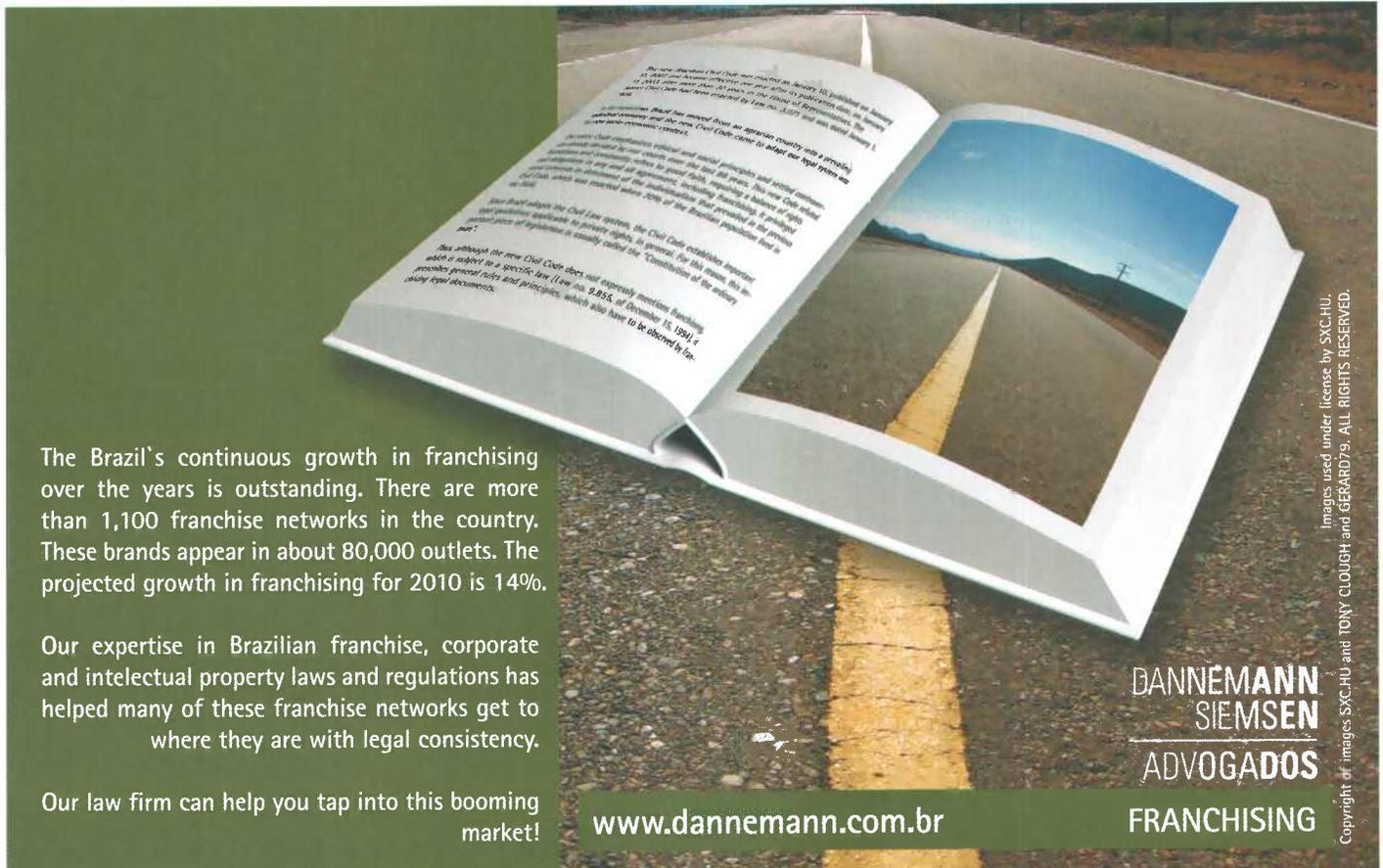
The large investment exemption under the FTC Rule applies to franchisees making a large investment into the franchised business. To qualify for this exemption, the franchisee’s initial investment must exceed \$1 million, excluding any financing received from the franchisor or its affiliates, and excluding the cost of unimproved land. The initial investment is limited to only initial costs (i.e., the costs described in Item 7 of the franchisor’s disclosure document), not the investment that the franchisee may make over the life of the franchised business. In addition, to qualify for this exemption, the franchisee’s investment must come from a single investor rather than a group of investors whose investments together total at least \$1 million. Franchisors who rely on the large investment exemption must obtain from applicable franchisees a written acknowledgment (using language mandated by the FTC) verifying the

grounds for the exemption.

Several franchise registration states also have exemptions that are based upon the size, net worth or sophistication of the franchisee. These exemptions vary by state and include exemptions for sales to high net worth franchisees, sales of franchises that require substantial investment, and sales to experienced franchisees.

**High-Net-Worth Franchisees:** Some franchise registration states have an exemption for franchise transactions with high-net-worth franchisees. The requirements for these exemptions vary: some require the franchisee’s income during each of the previous two years to have exceeded a certain amount (in all cases \$200,000), and others require the franchisee (or its parent or any affiliates) to be an entity in business for at least five years and have a net worth of at least \$5 million. One state (Washington) exempts sales to “accredited investors” who are individuals with a net worth over \$1 million (alone or jointly with spouse) or who have had an income over \$200,000 (or a joint spousal income over \$300,000) for the preceding two years, or to entities with a net worth over \$5 million. If the exemption criteria are met, the franchisor need not comply

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with disclosure or registration requirements in the registration states that offer this exemption.

**Substantial Investment:** Similar to the large investment exemption under the FTC Rule, some states have exemptions for substantial investments to be made by franchisees. The minimum amount of the investment generally varies from \$750,000 to \$1 million. In one state (Wisconsin) the investment must be at least \$100,000 and also cannot exceed 20 percent of the franchisee's net worth. As with the large investment exemption under the FTC Rule, there are additional conditions and requirements in some states, such as the fact that the investment cannot include any financing received from the franchisor or an affiliate, or the cost of unimproved land.

In all of the states with a substantial investment exemption except for one (South Dakota), franchisors relying on the exemption must provide disclosure to the prospective franchisee making the investment. It is therefore an exemption only from those states' registration requirements. Additional procedures may be required, such as applying for the

exemption, or filing an annual notice of exemption.

**Seasoned or Experienced Franchisees:** Although, as noted above, several states consider a franchisee's experience in determining the availability of certain exemptions, only California offers an exemption based solely upon this criterion. This exemption is available if the franchisee's owners have, within the seven years preceding the franchise sale, at least two years of experience managing the financial and operational aspects of a business similar to the franchised business. Transactions in California with franchisees meeting the requisite experience are not subject to California registration or disclosure requirements.

Whether a particular franchise sales transaction is exempt from applicable federal or state law is a complicated dance between the facts and exemption requirements. Exemptions may not be available from both federal and applicable state law, and even if a state exemption is available, the franchisor must be clear on whether the exemption applies to both the state's registration and disclosure requirements. There are other considerations; for example, other state laws, such as anti-fraud protections, will still apply even if a transaction is

exempt from disclosure and/or registration requirements. Franchisors who believe that they or their prospective franchisees are likely to meet the criteria for one or more exemptions would be prudent to consult franchise counsel before proceeding.

The relative size and experience of a franchisor and its prospective franchisees may thus be an advantage for obtaining certain exemptions. From a practical standpoint, however, many franchisors considering such size and experience based exemptions have already prepared disclosure documents, and may even hold applicable state registrations. But under the right conditions, taking advantage of size and experience exemptions can save a franchisor both time and expense when selling franchises. ■

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