The Key To Franchise Compliance: Controlling The Point Of Purchase

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[This article is the second in a series on achieving full compliance with franchise sales laws and regulations.]

Every feature of a franchisor's internal registration and disclosure compliance program revolves around a single event: execution of the franchise agreement. It is at this point that franchisors have their greatest opportunity to correct any errors that may have occurred in the sales process. Each franchisor must ensure not only that all pre-sale disclosure laws and regulations have been complied with, but also that all legal documents are in proper order for execution.

For these reasons, the techniques available to franchisors and their counsel for assuring full compliance with franchise regulations when the franchise agreement is executed have received a considerable amount of discussion at this year's IFA Legal Roundtable Seminars. This article will review many of the suggestions and current practices now being employed by compliance-cautious franchisors.

I. The Closing

Many companies suggest organizing a formal closing conference at which the franchisee, his or her counsel, the franchise sales representative, a member of the franchisor's senior management, and franchisor's counsel take the final legal steps in creating the formal franchise relationship. An essential element of this closing conference is the presence of senior management who was not involved in the sales process (but perhaps is ultimately responsible for it). His or her distance from the sale will allow for an effective double-check on the statements or mistakes made in the course of the sale. This final pre-sale conference between the parties bears some similarity to a real estate closing; however, all too often franchisors are less prepared and organized at their "closings" than their legal counterparts in real estate transactions.

The principal role of the senior manager is to ensure that all registration and disclosure laws have been complied with and that documents which have been delivered to the prospective franchisee are in order. Specifically, the manager needs to verify that the documents are state specific, and that the delivery date and timing are within the limits dictated by the various federal and state regulations. In addition, the manager must assure that no unauthorized earnings claims were made during the sales process that might later haunt the company.

The franchisor cannot afford to be lax at this time, since the future success of the franchisor's system is often dependent upon avoidance of post-sale legal action by franchisees or state administrators. The franchisor must be able to document which disclosure was delivered and received, at what time, in which state, and to whom. We have seen an increasing number of problems surface recently due specifically to inadvertent mistakes in pre-execution compliance. However, as discussed below, innovative approaches may be employed by franchisors to avoid the serious problems that can flow from a noncomplying franchise sale.

II. Documentation of the Sale

As with a real estate closing, a number of purposes are served at the franchise closing conference. Legal documents are to be signed and compensation is to change hands. Due to the exacting requirements of the franchise investment laws, steps must also be taken to assure that every aspect of franchise law compliance has been satisfied. For example:

—Was the correct document delivered?
—Is the company's registration effective in the state(s) affected by the sale?
—Was the requisite "cooling off" time of ten business days allowed prior to the closing conference?

—Was the final form of the franchise agreement delivered at least five business days before the closing?

—Are all necessary state addenda attached to the franchise agreement?

Additionally, the senior franchise executive should review with the prospective franchisee all statements made and answer any questions that might be pertinent to the sale:

—Were any unauthorized earnings claims made by the salesman?

—Has the prospect had an opportunity to review the disclosure document and the franchise agreement?

—Are there any questions or reservations that have not been fully answered?

Many franchisors have also started to record the closing conference in a permanent form, perhaps due to the recent cases concerning franchisee suits for rescission and damages claiming improper disclosure practices. Some companies have actually made audio or video tapes of the closing, giving copies to all parties. This establishes an oral transcript of representations made and risks acknowledged by the franchisee in the event a question is later raised.

More common is the creation of an exact written record of the transaction. Such documentation protects the franchisor in case of any future problems and, in addition, serves to signal to the franchisee the significance to the company of its adherence to the franchise sales laws. The paper record may take several forms. For instance, some franchisors have, in addition to producing a transcript of the closing, added to the disclosure document a "super-acknowledgement" page. Such a document requires that the franchisee date and initial several commonly disputed issues that arise in negotiations between franchisors and franchisees.

For example, a super-acknowledgement page will ask a franchisee to date and initial information explaining when he or she first received an offering circular or the date of the first face-to-face meeting with a representative of the franchisor.

Following this article is one version of a super-acknowledgement page distributed at a Legal Roundtable Seminar by moderator Don Drysdale, General Counsel of Coldwell Banker Residential Affiliates, Inc. (Another useful document in this area is the "Compliance Officer Checklist" distributed as part of the teaching materials in the Legal Roundtables this year and published with the first article in this series (FLD May/June 1986).)

As an alternative to a super-acknowledgement page, some franchisors deliver an orientation pamphlet to the prospective franchisee spelling out the key issues and enforcement policies of the company, as well as describing the laws which will regulate the relationship between the franchisor and the franchisee.

Through a combination of involved senior management, a careful system of written checklists to ensure the accuracy of the franchisor's pre-execution activities, and well established sales procedures, the franchisor may simultaneously guard against violations of the registration and disclosure laws and ensure the accuracy of their own records. It is essential to the franchisor to establish accurate and well-organized files at the onset of the franchise relationship, so that the documents generated as the relationship continues will be maintained in an orderly fashion.

III. Internal Controls

Many companies have also established a rigorous set of internal checks and double checks on the sales process, principally through internal observation and review procedures designed to monitor the sales process. In our view, there is no substitute for regular training of sales staff in the company's policies toward compliance with the franchise laws, and counsel should play a significant role in this education process. Sales representatives should be advised by counsel that they should handle every inquiry, every telephone call and letter, every personal sales call, and every interview as if the prospect were an investigator from a state Attorney General's office.

An even more effective method is to advise the sales staff that unidentified members of outside counsel's office will be posing as franchise prospects, carefully recording statements made and information distributed, and reporting observations back to company management. This alerts the sales staff from the beginning to document their activities carefully and to exercise due caution in all verbal statements made about the franchise investment. The final step is to have an attorney or paralegal from counsel's office actually apply to buy a franchise. In addition to the check on the sales staff, this procedure will allow the franchisor an objective observation of its entire presentation.

Another valuable measuring device of a franchisor's presale presentation and sales methodology is to conduct a post-sales interview with a prospective franchisee who came through the sales process but did not consummate the sale. Question why the sale was not finalized and, more importantly, ask for the prospect's most candid impression of your sales force.

IV. Conclusion

The franchise sales laws regulate all pre-sale activity, from the initial contact to the execution of the franchise agreement. Franchisors with the strongest compliance programs concentrate their attention, their documentation, and their management controls at the point of execution of the franchise agreement, the final—and most critical—step in the franchise selling process.

ACKNOWLEDGMENT OF RECEIPT BY PROSPECTIVE FRANCHISEE

A. THE FOLLOWING DATES ARE TRUE AND CORRECT:

1. ______________________, 19___. The date on which I received a Disclosure Statement (or Uniform Franchise Offering Circular) about the ______________ ______________ franchise.
   Month/Day

2. ______________________, 19___. The date of my first face to face meeting with a ______________ ______________ Franchise Marketing Representative to discuss the possible purchase of a franchise.
   Month/Day

3. ______________________, 19___. The date when I received a completed copy (other than signatures) of the Franchise Agreement I later signed.
   Month/Day

4. ______________________, 19___. The date on which I signed the Franchise Agreement.
   Month/Day

5. ______________________, 19___. The earliest date on which I delivered cash, check or other consideration to the Franchise Marketing Representative.
   Month/Day

B. REPRESENTATIONS:

1. No oral, written or visual claim or representation, which contradicted the Disclosure Statement, was made to me, except:
   ____
   ____
   ____
   ______________________________. (If none, the prospective Franchisee shall write "none.")

2. No oral, written or visual claim or representation, which stated or suggested any sales, income or profit levels, was made to me, except:
   ____
   ____
   ____
   ______________________________. (If none, the prospective Franchisee shall write "none.")

Date: ______________________

PROSPECTIVE FRANCHISEE:

____

By: ______________________

By: ______________________

(If a corporation, must be signed by each person owning any share(s) of any class of stock of the corporation.)

The above is true and correct to the best of my knowledge.

APPROVED BY:

By: ______________________

Title: ______________________

____
Marketing Representative