KTS Franchising Law Guides

Franchise Disclosure Documents

Updates 2020

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It's the time of year when most franchisors start to think about FDD updates. Under the Federal Trade Commission (FTC) Franchise Rule, the FDD must be updated within 120 days after a franchisor's fiscal year end. For franchisors with a fiscal year that ends on December 31, that means that the FDD update should be completed on or before April 30. The deadline for the FDD update should also take into account a franchisor's current state franchise registrations[1]. If the FDD is not updated by the expiration of the applicable deadline, the FDD becomes "stale" which means the franchisor cannot offer to sell franchises until the FDD is updated, and, if applicable, the updated FDD is cleared by the relevant registration state.

It is critical that a franchisor coordinate with its legal counsel and auditor well in advance of the FDD update deadline. Depending on the complexity of the FDD, the legal portion of the FDD update may take anywhere from two weeks to a few months to complete. Franchisors with a December 31 fiscal year end should arrange for the audit sometime in December, and make sure that their auditors are aware of the April 30 FTC Franchise Rule deadline and any earlier state filing deadlines. In our experience, it is best to commence both the audit and the legal portion of the FDD update sometime in January.

Most franchisors consider the annual FDD update season a time-consuming and distracting process. However, it also presents an excellent opportunity for a franchisor to perform a "check-up" on its current legal documentation. At a minimum, a franchisor should confirm that the FDD accurately reflects the current franchise offering and any material changes that have taken place during the past year. We recommend that franchisors also take this opportunity to evaluate any substantive changes that should be made to the franchise offering and franchise documents in light of recent legal and other developments, especially if your FDD has not been carefully reviewed in recent years. A lot has transpired over the past decade, and this is particularly true over the past year due to several recent developments in the areas of joint employer, employment misclassification and privacy and data security laws over the past year. In addition, the 2019 audit must take into account significant changes in revenue recognition rules that became effective in December of 2018.

Below is an overview of current developments affecting franchisors that we recommend that you evaluate when considering whether substantive changes to your FDD are needed in 2020:

1. Joint Employer Liability, Employment Misclassification and AB-5.

In recent years, in response to court decisions and legislation in the areas of joint employer and employment misclassification, many franchisors have revised their franchise documents to remove any hint of control over the essential terms and conditions of a franchisee's employees. Court decisions in 2019 continued to cast doubt over the types of controls that a franchisor can safely exercise without risking liability as an employer, even where those controls arguably involve the protection of brand standards.

In 2019, the most important legal development in the employment misclassification area is the adoption of California Assembly Bill-5 (AB-5) by the State of California. This contentious piece of legislation essentially adopted the ABC Test in California for determining whether a worker is an employee or independent contractor under wage and hour laws and other California employment laws. The ABC Test that is widely considered the most difficult of all of the employment tests. It presumes that a relationship is an employment relationship, and the burden of proving otherwise is placed on the hiring company. When literally applied, most franchisees (and their employees) are arguably the employees of their franchisor. The immediacy of AB-5 is most keenly felt in California, however, many states have used the ABC Test for many years to determine employment status under wage and hour laws and other employment statutes. If "as California goes, so goes the nation" is true, the door may be opening wider for the adoption of similar laws in more states that make it difficult to classify workers as independent contracts.

We believe continued litigation involving the franchise relationship in 2020 is likely due to uncertainty in the area of joint employer and employment misclassification liability caused by AB-5 (and similar laws) and recent court decisions blurring the line between employee and independent contractor. Prudent franchisors should continue to evaluate their franchise system in view of joint employer and misclassification risk. Every system is different and, unfortunately, there is no one size fits all. However, control is nearly always a factor in determining liability under joint employer and employment misclassification tests. As a part of the 2020 FDD update, franchisors should consider the types of controls that are truly necessary to preserve and promote brand standards, and controls that can be cut back. Many franchisors find that many things that are currently expressed as legal mandates can and should be reframed as guidance, recommendations or "best practices".

If your franchise system has locations in states that have adopted the ABC Test, the analysis is more complex, and often involves a lot more creativity. An evaluation of potential franchisor liability due to misclassification under the ABC Test primarily involves assessing the independence of the franchisee and the extent to which the franchisor's business is distinct and separate from the franchisee's business. Specifically, the following areas should be considered (a) the nature of the customer relationships (does the franchisor or the franchisee generate and "own" the customer accounts?); (b) the flow of the funds (does the franchisor or the franchisee collect customer payments?); (c) whether a franchisor has corporate locations, (d) the sophistication and size of the franchisee; and (e) the types of operational and other controls that a franchisor has in place.

We have found that there are often no easy answers for franchisors attempting to mitigate potential liability under ABC Tests. The changes that are necessary to insulate the risk of misclassification often entail fundamental changes to the franchise system that are at odds with the business realities. In these situations, it is even more crucial that franchisors consider including a mandatory individual arbitration clause in franchise agreements. If the franchise agreement already contains a mandatory individual arbitration clause, it is advisable to review that clause to ensure that it is well-drafted and comprehensive.

2. Data Privacy and Security Laws.

All 50 states now have data privacy laws which require an organization to disclose a data breach to affected individuals. In addition, there are a number of industries that have developed their own data security practices, most notably credit card companies, and several industry-specific privacy laws, such as HIPAA, the Health Insurance Portability and Accountability Act. On January 1, 2020, the California Consumer Privacy Act took effect (the "CCPA") which imposes requirements in connection with the collection and use of personal data. Other states are currently introducing bills that are based on the CCPA.

Recent FTC actions and court decisions have held franchisors liable for data breach even where the cause of the breach was a franchisee's failure to comply with privacy laws. Liability is often premised on a franchisor's selection of POS and other computer systems that a franchisee must use in its operations. Franchisors have also been held liable on the basis that they "allowed" the breach to happen due to inadequate data security policies or controls. Aside from the potential for legal liability, a major data breach could cause serious reputational damage to the overall brand.

For these reasons, protecting data privacy is clearly an extremely important issue for franchisors, and will likely become even more important and complex in the 2020s. Our recommendations in this area for 2020 include:

- carefully analyzing cyber policy requirements and permissible policy exclusions. Cyber policies can cover a broad range of injury including disclosure injury, content injury, reputational injury, notification expense, and crisis management expenses. Insurance carriers are quickly incorporating exclusions to cyber policy coverage and relying on these exclusions to deny coverage;
- requiring that the franchisee be responsible for maintaining and protecting personal data, and permitting immediate termination of a franchisee that is not complying with these requirements. This could be important if a franchisor needs to terminate a franchisee due to a large scale data breach caused by the franchisee;
- updating the operations manual to address current data security requirements;
- requiring that a franchisee provide prompt notification if there is a data breach, and cooperation, including access to the franchisee's systems to stop the attack and conduct an investigation;
- prohibiting the franchisee from making public statements about the breach without approval; and
- requiring a separate indemnity for costs and claims associated with data breach.

3. Accounting Rule Changes.

For most franchisors (unless they are public companies), ASU 2014-09, "Revenue from Contracts with Customers" becomes effective after December 15, 2018, and, therefore, applies to the preparation of the 2019 audited financials. Under ASC 606, franchisors can no longer recognize 100% of the initial franchise fee as revenue. Instead, a franchisor can only recognize that portion of the initial franchise fee that relates to upfront goods and services provided by the franchisor that have "stand alone value."

The new revenue recognition rules will drive many franchisors into a lower or even negative net worth. This may impact a franchisor's ability to attract prospective franchisees, impede state franchise registrations, impair the availability of real estate and put franchisors in violation of loan covenants.

A franchisor should consider whether it provides any distinct goods or services that would permit recognition of a portion of the initial franchise fee when that good or service is delivered. Items that are provided as a part of the brand cannot be separated.

Ultimately, the application of the revenue recognition rules is determined by a franchisor's auditor. However, careful drafting of the FDD and other franchise documentation can be helpful in supporting a determination that a portion of the initial franchise fee should be recognized on the delivery a separate and distinct good or service by a franchisor.

In most franchise registration states registration generally is valid for a one-year period. However, California, Hawaii, Minnesota and New York tie the registration period to the franchisor's fiscal year. In Minnesota and New York, registration of a franchise offering expires 120 days from fiscal year end. In Hawaii, registration expires 90 days from fiscal year end, and in California, registration expires 110 days from fiscal year end.

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