STEPHEN A. COLLEY
A PROFESSIONAL LAW CORPORATION
11622 El Camino Real, Ste. 100, San Diego, California 92130
Telephone: (858) 259-0888 Fax: (858) 348-1729 E-mail: colley@colleylaw.com

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VIA E-MAIL

Department of Financial Protection & Innovation
Lindsay Nelson, Counsel
320 West 4th Street, Suite 750
Los Angeles, CA 90013
Lindsay.Nelson@dfpi.ca.gov

Re: App-19407 - Deli Delicious

Dear Lindsay, Esq.:

This letter is in response to your comments regarding the above referenced application. I apologize for the time it took to respond but the client had unrelated issues to address and determining the "sold but not opened" list was complicated (discussed below).

Notice of Violation.

I have also included a Notice of Violation and the $675 (paid as required). The applicant provided an extension at the end of a 10-year term for an existing franchisee and since they were delayed in obtaining the renewal, it was a violation. The second exhibit will be the FDD being filed separately, online today as well.

FDD for 2020

As you may recall the client did not meet the renewal deadline in 2020, so the filing made on October 29, 2020, was for the year ending 2019 (and treated as a new application). As the renewal process continued, it became clear in early 2021 that this filing should be treated as a filing for the year ending 2020 and that the order granting approval should extend to April 20, 2022.

Financial Statements.

Their financial statements are not as strong as last year's for many reasons, which my client believe were caused by one-time events. Of course, there is Covid-19. My client made major concessions on royalties for all of its franchisees by creating a scale where the lower end paid no royalties and it stepped up with the best producing stores paying the highest, but which was substantially less than normal for all stores. This lasted from April 2020 through November at a loss of about $250,000 in royalty income. They had one franchisee that simply stopped paying and that resulted in a $50,000 loss. Fortunately, first quarter 2021, shows that the system is about back to normal. The litigation discussed below also cost my client over $300,000 to date.

Litigation.

The difficulties began with a son (Hadi) of the founder having a major falling out with his father. He made it clear he was going to be very vindictive and promised to destroy the company—I know it sounds excessive, but an officer of the Franchisor, Mr. Ali Nekumanesh, heard him say it, and the son has gone to great lengths to harm the business. He and two other franchisees carried out a campaign of publishing false statements to local newspapers and on the web. Two years ago, two franchisees, friendly with Hadi, filed a complaint with examiner Ms. Small who eventually determined it was not a franchise issue, but it had the desired effect of delaying the renewal by over 2 months.

In the current litigation the source of the problem is that the franchisor's affiliate makes bread for all the stores having replaced a baker who was friendly with the complaining parties. Several customers made complaints with store owners regarding the freshness of the bread which my client believes are frivolous claims.

My client obtained a temporary restraining order and recently on March 24, 2021 (as shown in the Auditor's notes) also was granted a Temporary injunction and the plaintiff was assessed a $1,500 penalty for leaking information from sealed deposition testimony.

This whole matter appears to be coming to an end with upcoming arbitration.

The other claim is by a former employee regarding a wage and hour matter but would not have been necessary to report except he alleged fraud.

Our Responses to your comments.

1. Please reformat the federal cover page to conform to the sample cover page on page 27 of the FTC Compliance Guide. The paragraphs should be in the same order as the sample and the entire cover page should be in standard sentence case.

   DONE.

2. On the Special Risks to Consider cover sheet, please remove paragraphs 2 through 6 because they are not approved uniform risk factors.

   DONE.

3. On Special Risks to Consider cover sheet, insert the following risk factors:

   a. **Negative net worth.** The franchisor's financial condition as reflected in its financial statements (see Item 21), calls into question the franchisor's ability to provide services and support to you.
   b. **Unregistered trademark.** The primary trademark you will use in your business is not federally registered. If the franchisor's right to use this trademark in your area is challenged, you may have to identify your business and its products or services with a name that differs from that used by other franchisees or the franchisor. This change can be expensive and may reduce

brand recognition of the products or services you offer.

c. **Spousal liability.** Your spouse must sign a document that makes your spouse liable for all financial obligations under the franchise agreement even though your spouse has no ownership interest in the franchise. This guarantee will place both your and your spouse's marital and personal assets, perhaps including your house, at risk if your franchise fails.

DONE, EXCEPT FOR b. MY CLIENT DOES HAVE FEDERALLY REGISTERED TRADEMARKS AND ITEM 13 HAS BEEN AMENDED ACCORDINGLY.

4. The FDD contains many disclosures that are not required nor expressly permitted. For example, Item 1 contains trademark disclosures that should be in Item 13. Item 1 also contains several prohibited disclaimers such as the last two paragraphs above the "Laws and Regulations" heading and the last three paragraphs before Item 2. Item 2 contains references to franchise brokers and a referral program, which are not relevant to the business experience of the managers. Item 6 contains insurance disclosures that should be disclosed only in Item 8. Please review each item and remove all disclosures from the FDD that are not required or expressly permitted by the FTC Franchise Rule in accordance with the FTC Compliance Guide.

   We have made various changes in the FDD.

5. Please reformat the Item 3 disclosure to conform to the formatting in the FTC sample on page 41 of the FTC Compliance Guide.

   DONE. The format was adjusted.

6. The Department is aware of other pending litigation that is required to be disclosed in Item 3. Please make all required litigation disclosures in accordance with the FTC Franchise Rule. See FTC Compliance Guide pp. 34-41.

   DONE.

7. The Franchisor must be able to meet its obligations listed in the FDD without relying on the initial franchise fee. In Item 5, please remove the statement, "The Initial Franchise Fee is payment, in part, for expenses incurred by us in furnishing assistance and services to you as set forth in the Franchise Agreement".

   DONE. The sentence was altered to show that the Franchisor does not rely on those funds. I believe there is also an accounting reason to show how the services align with the Initial Franchise Fee.

8. In your response letter, please explain how the Option Agreement described in Item 5 complies with California Corporations Code section 31119(a).
   In order to clarify that the Optionee will have been delivered the FDD and had it for at least 14 days, that requirement has been added (also a blank space to be filled in has been added to show whether it will be for an initial purchase or an additional purchase). This provision regarding the option complies with California Corporations Code section 31119(a).

   See Changes on Exhibit 6 in the FDD.

9. In Item 6, please disclose the amount a franchisee will pay for the inventory of Deli Delicious products.

Because the price is set by the Franchisor or its affiliates, the Franchisor should have this information available to disclose to potential franchisees.

The Franchisor's recommendation for inventory is now set forth in Item 6.

10. Item 6 Note 1, please clarify the index, either remove or clarify which one the franchisor is choosing from.

    The language in Item 6, Note 1 regarding the index has been changed.

11. In Item 6, please state in Note 4 that the interest rate cannot exceed 10% per year in California.

    DONE.

12. In your response letter, please provide more information about the inspections described in Item 8. How many inspections were done and how much fees did the Franchisor collect in 2019?

    There were 40 inspections in 2019, and no fees were charged.

13. Please identify the affiliate that owns the bakery facility referred to in Item 8.

    DONE. The affiliate that owns the bakery is included in Item 8.

14. In Item 12, please change the term "protected territory" to "exclusive territory". The Department requires accurate use of terms of art and "protected territory" is a term of art used for nonexclusive territories.

    DONE.

15. In Item 15, please insert, "No-poaching provisions in contracts are against California public policy. Therefore, we will not enforce the no-poaching provision in California."

    DONE. Language was added to address this.

16. In Item 16, please insert in the third paragraph, "Under California law, an agreement between a seller and a buyer regarding the price at which the buyer can resell a product (known as vertical price-fixing or resale price maintenance) is illegal. Therefore, requirements on franchisees to sell goods or services at specific prices set by the franchisor may be unenforceable."

    DONE.

17. In Item 20, please format the tables so that the title of each table is on the same page as its respective table.

    DONE.

18. Please provide the Department with a list of the 58 franchisees that have signed franchise agreements but have not opened an outlet. Include, in table format, when the franchisee signed the agreement and the amount of franchise fees that each franchisee paid.

We have determined that the great majority of these 58 are for options that were acquired under provisions for the sale of options under Exhibit 6. My client had mistakenly included the options in the same category as franchisees who "have signed but have not opened". But they have <u>not been including these options</u> <u>as franchise outlets under Tables 1-4.</u> They have also been carrying forward (and making up part of the 58) very old franchisees who never opened.

The option right only last for 1 year but for the most part the Franchisor has been carrying them on their books which was part of the problem. My client was not aware of the distinction between a franchisee who has not opened and a franchisee who owns an option (unexpired option.) Further they had been carrying franchisees that passed the deadline to open years ago.

Therefore, Table 5 is revised to show the accurate number of signed but not opened franchises.

The final count was that there were 36 options that had been sold but were never exercised and there were 22 franchise sales whose owners never opened. Of those 58, there were 8 sales of franchises which are still considered viable, but which have not opened yet. It is these 8 that make up the sold but not opened category.

They have attempted to contact or actually contacted all of these franchisees referred to and all but these 8 are treated as abandoned.

All of those franchisees that are now listed in Table 5 as having "signed but not opened" are shown in Exhibit 7 (List of Franchisees) with a designation showing they are not open (some indicate the site is yet to be determined).

The chart ("Prior Sales") for the information you requested is attached but let me make a few comments so it can be understood. It lists only franchisees that did open and holders of options that did not exercise EXCEPT those 8 viable franchises are NOT listed. In some cases, a franchisee (who opened or may not have opened) had purchased no options and in other case anywhere from one to 4 options had been purchased. So, if the chart shows zero options sold for a particular person, that means the franchisee had bought a franchise (but not an option) and did not open its franchise. All options were purchased only by franchisees. All on the list are considered abandoned.

19. In Item 20, please disclose the franchisee association referenced in the November 2019 post-effective amendment the Franchisor filed with the Department.

This has now been added back.

20. In Exhibit 2, please update this Department's name to Department of Financial Protection and Innovation and the Commissioner's title to Commissioner of Financial Protection and Innovation.

The new name of the "Department of Financial Protection and Innovation" was substituted.

21. In the California Addendum, please delete from the first paragraph, "Add to the Disclosure Document item 3, litigation, ~(c), that". Also change "Section 2" to "Item 2".

DONE.

22. In the last paragraph of the California Addendum, please update this Department's name and the website URL to www.dfpi.ca.gov.

DONE.

23. Based upon the audited financial statements and the Supplemental Information submitted, this Department will impose an impound. The depositary and purchase receipt must be approved by order prior to applicant's effectiveness. The depositary must conform with Title 10, California Administrative Code, Section 310.113.3. The agreement with the depositary should state that it will not release any funds, under any circumstances to anyone (including the investor), until it receives a written order from the Department of Business Oversight.

OK. My client will adopt the deferral of the initial franchise fee approach.

24. Notice of Violation. A franchisee extended (renewed) his franchise agreement earlier in 2020 but the Franchise registration had expired and so it was sold during a period when the franchisor was not registered. A separate application is being filed with a Notice of Violation and the $675 fee.

Very truly yours,

STEPHEN A. COLLEY, APC
A PROFESSIONAL LAW CORPORATION

By: ______________________

Stephen A. Colley
Certified Specialist – Franchise & Distribution Law State Bar of California, Board of Legal Specialization

SAC/bt/dr