

The Proposed Federal Trade Commission Franchise Rule

Some Selected Highlights

The Federal Trade Commission recently announced a proposed major revision (in what may be an almost perfect example of bureaucratise, the “proposed final revised Franchise Rule”, referred to in this article as the “2004 Proposed Rule”) to the federal rules affecting franchise disclosures.

As many of our clients and friends already know, the federal rules in this area set a minimum standard for compliance by all franchisors offering and selling franchises within the United States. While state laws and regulations may set higher standards for the protection of Franchisees, all Franchisors in the U.S. must comply with the FTC standards.

The FTC has been studying possible changes to the Franchise Rule since 1995, and the process should now be close to conclusion. The changes proposed are properly characterized as evolutionary in nature, not revolutionary.

While they do not represent any radically new approaches to franchise disclosure, they will require all Franchisors operating in the U.S. to revise their disclosure procedures and the contents of their disclosure documents.

From a policy standpoint, the proposals are, in our judgment, generally sound and constitute a worthwhile step forward in franchise disclosure regulation in the United states.

In essence, the 2004 Proposed Rule will accomplish three main objectives:

First, they will modernize the “mechanics” of disclosure, relating to when UFOCs are delivered, the use of alternative means of delivery, etc.

Second, they will change the content of disclosure documents. In a major departure, the FTC has adopted the Uniform Franchise Offering Circular (“UFOC”) format, eliminating the alternative FTC disclosure document (which almost no Franchisors use), but has made changes, many of them significant, to each of the items in the UFOC. Commentators have designated the proposed



new disclosure document the “UFOC Plus” and, in many areas, it requires significantly greater disclosures than were previously the case.

Third, additional exemptions from the coverage of the FTC Franchise Rule have been proposed, removing certain transactions and/or prospective Franchisees from the coverage of the 2004 Proposed Rule.

Readers should also note the following:

A. This paper touches on only some of the more noteworthy changes which the FTC has proposed, including those which we felt were of particular interest at this time. Numerous other proposed changes exist, many of which substantially affect the content of the UFOC Plus, including required notices and disclaimers, and the discussion below is, in the interests of brevity and readability, far from exhaustive. In particular, this paper is not a complete guide as to how to put together a UFOC under the 2004 Proposed Rule.

B. As noted above, the 2004 Proposed Rule is exactly that: proposed. It is not yet finalized and the FTC will be receiving comments and suggestions through November 12, 2004, some of which will be forthcoming from Holmes & Lofstrom, LLP, and others from the California State Bar Franchise Law Committee, with which members of our firm have been, and are, involved. Therefore, while most commentators, including those of us at Holmes & Lofstrom, believe that relatively few changes of any great magnitude will be made in the proposal, and that it will be largely adopted in its current form, the possibility of further changes cannot be entirely ignored and it is certainly possible that changes in a number of the details may still be forthcoming.

C. Since the 2004 Proposed Rule is still, technically, merely a proposal, no specific date for implementation has been set. We expect that Franchisors will be able to prepare their UFOCs to be used beginning in the Spring of 2005 on the current form and that the UFOC Plus form will not be implemented until 2006, but we will have to wait to see if that judgment is correct.

Being mindful of the above cautions, here are some of the more significant changes proposed by the FTC:

Disclosure Timing and Methodology

1. 14 Day Disclosure Period

The ten-business day rule, requiring delivery of a UFOC to a prospective Franchisee no less than ten business days before binding documents are signed or consideration paid, is changed to a 14 day rule, making the

calculation of the relevant disclosure period, and compliance by Franchisors, much easier.

2. 7 Day Re-Disclosure re Changes to Franchise Agreement

As knowledgeable franchising industry personnel are aware, under the current Rule, modifications to the Franchise Agreement attached to the UFOC, even if voluntarily agreed to by, and benefiting, the Franchisee, result in a requirement for re-disclosure of the modified agreement for five business days before binding documents can be signed or consideration paid. Under the 2004 Proposed Rule, a number of very sensible changes are made, with respect to re-disclosure of the changed franchise agreement:

- a. The five-business day rule is changed to a seven day rule.
- b. The five-business day rule is triggered when the Franchisor alters “materially and unilaterally the terms and conditions of the basic franchise agreement.”
- c. The 2004 Proposed Rule expressly states that “changes to a franchise agreement that result solely from negotiations initiated by the prospective franchisee do not trigger this seven-day period.” It may appear that, as a preliminary matter, that if a Franchisee initiates such negotiations, normal give-and-take concessions may be made by, and benefiting, both sides without triggering a need for re-disclosure.

3. Electronic Delivery

UFOCs may be delivered electronically, either by Internet or tangible electronic media, such as a Zip® disk or CD-ROM.

To make disclosure electronically, the following procedures have to be followed (note that other requirements, not discussed below, relate to all forms of disclosure, whether electronic or hard copy):

- a. The disclosure format must allow the prospective Franchisee to store, download, print or otherwise maintain the document for future reference.
- b. Extraneous information is prohibited. For the sole purpose of enhancing the prospective Franchisee’s ability to maneuver through an electronic version, scroll bars, internal links and search features may be included, but all other features (including multi-media tools such as audio, video or pop-up screens and, presumably, external links, such as

to an annual report to shareholders, franchise marketing brochure or otherwise) are prohibited.

- c. Before the Franchisor can provide a UFOC, it must advise the prospective Franchisee of the formats in which the UFOC is available, any prerequisites for obtaining the UFOC in a particular format and any conditions necessary for reviewing the UFOC in a particular format, presumably including necessary hardware and software.

4. Elimination of Requirement for Delivery of UFOC at the First Personal Meeting

Experienced franchising professionals are aware that, under the current FTC Franchise Rule, disclosure documents must be delivered no later than the “first personal meeting,” generally defined as a face-to-face meeting held for the purpose of discussing the sale, or possible sale, of a franchise.

In a commendable step forward, the FTC Staff has recommended that the first personal meeting “trigger” be eliminated, which (if adopted) will result in a simpler requirement that the UFOC merely be delivered 14 calendar days prior to signing of documents or payment of funds. This approach will significantly simplify the franchise sales process, especially when combined with the possibility of using electronic means of UFOC delivery.

UFOC Plus Content

Although only some of the more significant changes to the UFOC Items are discussed below, Franchisors will be required to make changes to most, if not all, of the items in their UFOCs.

Item 2

In a welcome change, Item 2 disclosures will no longer include disclosures with respect to brokers, vastly simplifying compliance problems for brokers and Franchisors alike.

Item 3

This Item contains a number of important revisions:

- a. Litigation involving a Franchisor’s parent company will generally be required only where the parent company has guaranteed the Franchisor’s performance.

- b. “Material” Franchisor-initiated litigation against franchisees “involving the franchise relationship in the last fiscal year” must be disclosed, although this can be in a summary form. This means that in situations where the Franchisor has sued a Franchisee, even though no counterclaim by the Franchisee has been filed, the litigation may be required to be disclosed.
- c. Disclosure is expanded to cover governmental actions involving affiliates of the Franchisor.
- d. Litigation involving brokers is not generally required to be disclosed.

Item 6

Payments by a Franchisee, which are required by the Franchisor but are made to a third party, will be required to be disclosed.

Item 12

This Item, concerned with territorial rights (often one of the most contentious areas between Franchisees and Franchisors), would be modified in two significant ways:

- a. The disclosure is broadened to provide prospective Franchisees with information regarding the Franchisor’s rights to use alternative channels of distribution, such as mail order, Internet sales, telemarketing or otherwise.
- b. If an exclusive territory is not granted, a specific warning must be included regarding possible competition from other Franchisees or Franchisor-owned outlets/alternative channels of distribution.

Item 19

This portion of the UFOC, relating to the question of potential financial results a prospective Franchisee might expect, has been changed in a number of significant areas.

- a. A non-significant change, but one which should be mentioned, involves terminology: The phrase “earnings claim” is replaced with the more general, and more accurate, term “financial performance representations.” It’s certainly possible that the old phrase will continue in use informally, at least for some time.

- b. Also, the core philosophical approach of old Item 19 is retained. Financial performance representations are not mandatory, but, if they are made, they must be made in the UFOC and in compliance with its requirements.
- c. Mandatory language must be presented in Item 19 regarding financial performance representations, including specific language if financial performance representations are not made.
- d. In a significant departure from current Item 19, the definition of “financial performance representations” does not include costs. Therefore, at least in theory, a Franchisor might be able to present cost information without triggering the need for an Item 19 disclosure. However, one should note that, in some circumstances, cost information can imply information regarding gross revenues or earnings and that any such attempt could run afoul of the FTC’s general prohibitions regarding financial performance claims.
- e. The requirement that financial performance representations meet GAAP standards will be eliminated.
- f. Finally, changes are made allowing Franchisors to present financial performance representations regarding subgroups of Franchisees (for example, “express” units or kiosks, compared to traditional full-sized or “brick and mortar” units), but should prevent Franchisors from “cherry-picking” their best producing units and presenting non-representative information inapplicable to the proposed Franchisee.

Item 20

Item 20 was the subject of extensive discussion, and the resulting changes reflect both “technical” fixes and those of more significance from a policy standpoint.

- a. The tables used to present information regarding franchise turnover (transfers, cancellations, non-renewals, re-acquisitions, etc.) have been revised to resolve issues related to “double counting”, such as when a franchise is terminated and then re-acquired, or in the case of an abandonment, followed by a termination, a re-acquisition and a transfer to another Franchisee.

Note that this requirement will mandate that Franchisors re-visit their files with respect to the categories covered by the new tables and prepare

revised statistical information. That process should be begun now, prior to the need to generate revised tables in the next year or so.

- b. The existence of confidentiality (or “gag” clause) agreements with Franchisees is addressed by requiring Franchisors to insert specified language in the UFOC regarding their existence. Franchisors may disclose the number and percentage of current and former Franchisees who have signed such agreements in the last three years, and the related circumstances.

Item 21

From a policy standpoint, perhaps the most interesting change to this Item is to allow Franchisors to use financial statements meeting either GAAP or SEC requirements, a wise initiative to reduce barriers to entry by non-U.S.-based Franchisors (whose financial statements may differ in some areas from GAAP) into the U. S. market.

Exemptions

International Sales

Consistent with case law on the subject, the FTC now clearly takes the position that the 2004 Proposed Rule only covers offers and sales of franchises “to be located in the United States of America, its territories, or possessions”, presumably excluding franchises located abroad but to be owned by U.S. investors. Note that the phrase “located in” may be subject to questions of interpretation, such as in instances where the franchised business is physically headquartered in a foreign country but may sell or provide products or services in the U.S.

Large Investment Exemption

Transactions in which the Franchisee’s estimated investment, excluding financing from the Franchisor or an affiliate, and excluding real estate costs, exceeds \$1,000,000 are excluded from the provisions of the 2004 Proposed Rule, if the prospective Franchisee signs an acknowledgement containing prescribed language.

Large Franchisee Exemption

Similarly, sales where the Franchisee (and any parent company or affiliates) is an entity which has been in business for at least five years, and has a net worth in excess of \$5,000,000 are also exempted, but no acknowledgement is required.

Officers, Owners and Managers Exemption

Finally, in an almost direct copy of a California statute on the subject, if one or more of the purchasers of at least a 50% interest in the franchise (1) within 60 days of the sale, has been (for at least two years) an officer, director, general partner, individual with management responsibility for the offer and sale of the Franchisor's franchisees or the administrator of the franchised network or (2) within 60 days of the sale, has been (for at least two years) an owner of at least a 25% interest in the Franchisor, the transaction is exempt.

Separate Treatment of Business Opportunities

Offers and sales of business opportunities will no longer be covered by the 2004 Proposed Rule, and will, in all likelihood, be the subject of a separate trade regulation rule.

What Happens Next

As noted above, the 2004 Proposed Rule is open to comment through November 12, 2004, and there are a number of areas where comments can be expected. However, it seems unlikely that significant changes will be made, although some clarifications and "fine tuning" is both possible and appropriate in some instances.

There is no time limit on the FTC Staff for review of any comments, nor any deadline for adoption of the 2004 Proposed Rule by the full Commission.

Once the 2004 Proposed Rule is adopted, based on past experience, there will be a phase-in period allowing Franchisors to comply with the 2004 Proposed Rule and for states to accept the new format, including making any related changes to their laws and regulations.

Finally, the FTC Staff has signaled that it will issue interpretive guidelines providing practitioners with direction as to the implementation of the new rules.

This material is presented for training and discussion purposes only. It is not descriptive of all elements of the Proposed FTC Franchise Rule, is based only on a proposed form of that rule which has not been finalized, and should not be used or relied on without first consulting an attorney who is an experienced franchise law specialist, and

discussing with him/her the facts and applicable law. Proceeding without the benefit of the advice of an experienced and knowledgeable franchise law specialist, specific to your fact situation, documents, business model, etc., is not recommended. © 2004 Holmes & Lofstrom, LLP