

Currency, Re-disclosure and “Who’s in the Pipeline?”

As Franchisors cycle through their annual renewal process, a series of practical questions come up regarding when prospective Franchisees need to be disclosed, how “current” UFOC's must be, and how all of this relates to fiscal year ends, state renewal deadlines, etc.

Let’s see if we can clarify some of those areas by providing some general guidelines, and then applying them to particular fact situations.

The “Current” UFOC – Registration and Non-Registration (“FTC”) States

Franchise sales professionals and franchising executives all understand that a prospective Franchisee needs to be disclosed on the “current” UFOC. Obviously, to give a prospect an out-of-date UFOC serves no legal purpose, and may result in significant legal liability for the Franchisor, its officers and directors and any franchise marketing personnel involved.

For example, assume that your UFOC was updated in March, as part of your normal renewal process. A prospect appears in your sales process in May. Clearly, she needs to be given the March UFOC, in order for a sale to be legally closed.

But suppose that, during the sales process, the UFOC becomes no longer up-to-date. Suppose, for example, that in June (the sale still not having closed) a litigation item is filed against the Franchisor, a new Senior Vice President of operations is hired and seven new Franchisees join the system, bringing the total to 13 (a material increase on a percentage basis.)

The prospect is now in possession of only the March UFOC, which is significantly out-of-date. For a sale to take place and be immune from attack on grounds that the prospect did not have the current UFOC in her possession at least 10 business days before signing or paying any sums, **she needs to be re-disclosed on a revised UFOC**, an appropriate receipt obtained, and the 10 and 5 business day rules complied with.

Otherwise, when the Franchisee fails in her business and sues the Franchisor, she’ll make the following claim:





“Sure, back in March I got a UFOC, and it was probably accurate when they gave it to me. But when I signed up in July, the Franchisor had been sued, a new member of senior management had joined the team and a whole bunch of new stores had opened.

I'd have loved to talk to those new owners to see how they were doing, would have been very interested in the bio of the new Senior VP and if I'd known that the Franchisor was in litigation, I probably would never have bought the deal.

The Franchisor knew all of those things, may have even filed an amendment to their UFOC showing them, but never gave me a copy. I was treated like a second-class citizen, misled and I want my money back plus damages! And I'm going to complain to state and federal enforcement agencies.”

Based on these facts, most arbitrators, judges and juries will be very sympathetic to the Franchisee and she may have what's close to a slam-dunk winner in litigation, as well as a complaint letter very interesting to state and federal officials.

Clearly, in order to avoid this type of scenario, what the Franchisor needs to do is:

1. During the sales process, keep track of which version of the UFOC has been delivered to each prospect. Review that file prior to closing and bring to senior management's attention any situation where there has been (or should have been) a new UFOC prepared between the date of the original UFOC delivery and the proposed date for closing the sale.
2. If changes are needed in the UFOC, amend it accordingly and make any necessary filings in registration states.
3. Re-deliver an amended UFOC to all prospects in the pipeline, obtaining the appropriate signed receipt and thereafter complying with the 10 and 5 business day rules with respect to waiting after re-delivery of the amended UFOC to sign documents, take funds, etc.



The **core principle** is actually very simple: At the time money passes hands and/or documents are signed, the prospect must have had in their hands (for the 10 business day period) a UFOC that was (a) totally up-to-date and (b) approved by the state, if a registration state is involved. If not, don't close the sale until the situation is remedied.

The FTC 90-Day Currency Rule – A Trap for the Unwary

As many Franchisors know, the FTC has what is commonly referred to as a “90-day currency rule.”

As applied to year-end financial statements and their impact on your UFOC, the application of the rule is relatively straightforward: Assuming that a Franchisor has a December 31 fiscal year, it is required to add the December 31 financials to the UFOC no later than 90 days after the end of the fiscal year, update the UFOC in all other respects, thereafter only use the new UFOC and, as mentioned above, re-disclose any prospects in the pipeline using the new UFOC.

What if the new financials are not available 90 days after the end of the fiscal year? The answer is as simple as it is painful: Stop selling franchises.

To fail to do so violates the FTC Rule (as well as the laws of any registration state involved) and seriously exposes the Franchisor. After all, if the new financials took seven months to be organized, few franchising professionals would argue that it's acceptable to continue to award franchises through July, using financials that, by that time, were over a year and a half old!

Another misconception should be cleared up: As a practical matter, the 90 day currency rule does not allow a Franchisor to delay updating a UFOC and complete sales using a UFOC that is out-of-date and materially inaccurate, certainly in registration states, and probably in non-registration states as well. A Franchisor who knowingly awards a franchise using a UFOC that is out-of-date and materially inaccurate runs serious risks, both under state franchise statutes and general legal principles. Therefore, under the core principle highlighted above, don't award franchises without the prospect having received the most recent, fully up-to-date UFOC.



Intersection with State Renewal Requirements

The above overriding principles sometimes confuse Franchisors when compared to state renewal requirements, but the requirements are really independent and don't overcome the core principle.

For example, assume that a Franchisor is required to renew its state registration in a particular state on July 1 (due to that being the anniversary of the date of original filing), even though the Franchisor has a December 31 fiscal year.

In essence, the Franchisor will do two filings each year: One before July 1 to timely effect renewal (think of this as being similar to renewing your driver's license) and one soon after December 31 to amend the UFOC, to include the new financials.

What's important to remember is that these are independent requirements and that a Franchisor is **not** allowed, after the December 31 financials are due (remember the FTC 90 day currency rule, which applies everywhere, including registration states), to wait until the July 1 renewal date to include the new financials in the UFOC. To do so, and to award franchises without those updated financials (or any other update information) would violate the core principle highlighted above.

Franchisors who find themselves in the position described above (e.g., required to comply with two separate updating periods) may be able to make a change for the better. Our firm has been relatively successful seeking and obtaining in various registration states an adjusted registration renewal date to enable clients to avoid this double filing scenario. If you would like us to make such an effort on your behalf, please contact us for assistance.

Amendment Requirements

In addition to the annual updating mandates of the FTC Rule and the registration states, Franchisors must comply with amendment requirements that are triggered by material changes in UFOC information. The FTC Rule requires a Franchisor to amend its document at least on a quarterly basis to "reflect any material change in the franchisor or relating to the franchise business of the franchisor". Registration states generally require a more prompt amendment, e.g., amendments to be made as soon as the material change occurs. Under any of these updating provisions, prospects must be re-disclosed with the amended UFOC and appropriate waiting periods respected before a sale can be closed.



What is a material change? It's a question that is often asked and frequently difficult to answer. Some material changes are clear-cut, e.g., a franchisee files litigation against a franchisor, a president is replaced, the royalty rate is adjusted, etc. Others are far less apparent. The question that has to be asked is, "If I am a prospective franchisee, could a reasonable argument be made that the inclusion (or omission) of this new information might influence my decision making process as to whether or not to obtain this franchise?" We recommend that we assist you in this evaluation process to help guide you in minimizing your potential exposure.

As always, call any of our attorneys specializing in franchise law for further information, or if you have any questions.

