



Holmes &  
Lofstrom, LLP  
FRANCHISE & BUSINESS COUNSEL

# THE PROPOSED FTC FRANCHISING RULE

## Major Changes from the UFOC and Related Business Implications

Presented by

Holmes & Lofstrom, LLP

Northern California Office

555 Chorro Street, Suite D-2  
San Luis Obispo, California 93405  
Phone: 805.547.0697  
Fax: 805.547.0716

Southern California Office

6621 Pacific Coast Hwy., Suite 250  
Long Beach, California 90803  
Phone: 562-596-0116  
Fax: 562.596.0416

Please visit our website at [www.HolmesLofstrom.com](http://www.HolmesLofstrom.com)

# THE PROPOSED FTC FRANCHISING RULE

## Major Changes from the UFOC and Related Business

### Implications

#### **INTRODUCTION**

As many of you may already know, since April of 1995, the Federal Trade Commission (“FTC”) has been considering changes to the disclosures currently required to be given by Franchisors to prospective Franchisees. That process is drawing to a conclusion, and we anticipate that within the next year the FTC will implement its final changes. These changes will affect Franchisors throughout the United States and are likely to require substantial revisions to Disclosure Documents currently in use, regardless of whether or not the Franchisor files in registration states.

The “Proposed Rule” under final consideration by the FTC is based on the current UFOC. The Disclosure Document format contemplated by the Proposed Rule differs from the current UFOC form in certain substantial respects. Once adopted, this format is intended to become the standard form of Disclosure Document permitted in the U.S., subject to state-specific provisions where state law provides greater protections to Franchisees.

The purpose of this paper is twofold. First, it is intended to analyze many of the more significant changes proposed to date. Our goal is to update businesspeople about, and to help them prepare for, anticipated disclosure changes. Second, it is to encourage all of us involved in the franchising arena to offer our input on the Proposed Rule during the short comment period that is expected to follow the upcoming release of the revised Rule. The current best estimate as to timing of the release is year-end 2002. The final form of Rule is expected to be adopted in early 2003.

In reviewing the following pages, two points should be noted:

First, the FTC may make additional changes between now (Fall of 2002) and the date when the Proposed Rule is finalized. The FTC has

received feedback on a number of the outstanding issues addressed in this document. Therefore, it is hoped that many of the concerns identified will be eliminated in the version soon to be released. Additionally, the final Rule may be modified as a result of input to be provided by our firm and from other practitioners, Franchisees and franchise companies during the final comment period as noted above.

Second, the proposed changes we've focused upon are those that, in our judgment, seem most significant from a business standpoint. The intended audience for this paper is primarily businesspersons, not lawyers or paralegals. You should be aware that this discussion is not intended to be exhaustive or complete. For example, there are proposed changes of great interest to the legal community that are not addressed here because they do not have the potential business consequence that those described below may have.

## **CHANGES IN UFOC ITEMS UNDER THE PROPOSED RULE (AS OF 11/1/02)**

### **Cover Page**

The UFOC will now be called a "Disclosure Document" and will no longer have an FTC page in addition to the old UFOC cover page. Instead, there will be a single cover page providing most of the information previously required. Additions to the old information will include:

1. A reference to the FTC's home page (containing resources on franchising) and to the FTC's Guide to Buying a Franchise.
2. The Franchisor's E-mail address and its primary Internet home page address.
3. Certain specified statements if the Franchisor wishes to use electronic delivery of Disclosure Documents (an option we suggest be preserved).

A significant change is that where the old UFOC required mention of various risk factors if present in the franchise (whether or not called out by state regulators), the Proposed Rule mandates inclusion of risk factors only if required to be included under relevant state law.

## **Item 1 – The Franchisor, Its Parent, Predecessors and Affiliates.**

Here, the Proposed Rule makes what will be some very significant changes for at least some franchise systems.

Most importantly, the Proposed Rule now requires information regarding **any** “parent” of the Franchisor. The existing UFOC has no such requirement. Under existing requirements, Item 1 information regarding an affiliate (which may or may not be a parent company) is necessary only if the affiliate is offering any kind of franchise or is providing products or services to the Franchisor’s Franchisees.

The term “parent” is undefined, leaving its intended reach and application unclear. The consequence of this ambiguity is compounded by the fact that information regarding a “parent” is mandated not only in Item 1, but in numerous other items, as well. As it stands, the prescribed information is required regardless of whether or not the parent is involved in franchising or connected in any way to the franchising activities of the Franchisor. Lastly, neither “parent” nor “affiliate” are defined to exclude a natural person.

An expanded definition of “predecessor” may be equally impactful. In addition to being the person from whom a Franchisor acquired the major portion of its assets, a predecessor also may be any person “from whom the Franchisor obtained a license to use the trademark or trade secrets in the franchise operation.” This definition presents a number of hurdles that hopefully will be minimized in the upcoming version. The definition does not allow for any distinction between trademarks or trade secrets currently employed in the system vs. those that might have been used in the past. Nor does it employ any materiality standard. Since a predecessor is identified from the immediately preceding 10-year period, theoretically a person that licensed an inconsequential mark to a system for a one-year term five years ago would be captured by the definition.

These expanded definitions will have a cascading effect throughout the Disclosure Document (as noted below), potentially involving increased disclosures in a number of Items.

## **Item 2 – Business Experience.**

This Item is substantially the same as under the current UFOC, but adds a requirement for disclosure of the business background of any director or officer of any parent, if that person will have management responsibility relating to the franchise being offered. This raises a number of difficult questions regarding the involvement of parent company personnel in a Franchisor's business affairs.

Suppose, for example, that the CEO of a Franchisor's parent is not an officer or director of the Franchisor, but participates in management meetings, sits in on strategic planning sessions, requires regular reports from the Franchisor's personnel regarding operational and financial matters, etc. Is she someone with "management responsibility relating to the offered franchises?" This change is reflective of the FTC's stated position that information on all persons having management responsibility is material to prospective Franchisees. Therefore, prudence suggests that information about our hypothetical CEO be disclosed. Practitioners are left wondering how far up the corporate chain this requirement extends.

### **Item 3 – Litigation.**

Two changes of potential significance to Franchisors occur in this Item, each expanding a Franchisor's litigation disclosure obligations:

First, the Proposed Rule will require disclosure of pending Franchisor-initiated lawsuits against Franchisees, if such suits involve the franchise relationship. This disclosure was not required under the UFOC (except when the Franchisee counter-claimed). The FTC has indicated that it may limit this type of disclosure to situations where the Franchisor has sued some specified percentage of its Franchisees.

Second, litigation disclosure requirements will apply to the Franchisor's parent (an undefined term, as noted in the discussion of Item 1). Again, note that this disclosure will be required even if the parent has no dealings with the Franchisees in the system and is not offering franchises in any line of business. Since the list of persons to be captured under the expanded Item 2 requirements is longer and the definition of predecessor broader, there is a potential for a substantial increase in the number of persons/companies with respect to which litigation must be reported.

From a business standpoint, these new parameters require Franchisors to explore the 10 year litigation history of persons/entities

from whom disclosures were not previously required, e.g. was a predecessor who licensed a trademark to the Franchisor five years ago a defendant in a material action involving an allegation of fraud in the past 10 years? Franchisors will want to begin at least considering how they will go about collecting such information if the final provisions are unchanged. Business considerations also may affect litigation strategy as a result of the new disclosure of pending Franchisor-initiated lawsuits against Franchisees. Would a Franchisor wait to file suit until it had other reasons to amend its documents and, therefore, potentially minimize franchise marketing delays?

#### **Item 4 – Bankruptcy.**

The major change to this Item is that, once again, disclosure of past or current bankruptcies of the Franchisor's parent is now required. Expanded definitions potentially broaden the scope of persons that may need to be listed in this Item, similar to the effect described regarding Item 3.

#### **Item 5 – Initial Franchise Fee.**

This Item remains substantially the same as under the current UFOC.

#### **Item 6 – Other Fees.**

Essentially, this Item is unchanged from the present UFOC Item 6, although the title may change to "Recurring or Occasional Fees."

#### **Item 7 – Estimated Initial Investment.**

The text of Item 7 is largely the same as under the current UFOC. However, the FTC discussion on this Item reflects a distinctly different approach to meeting these requirements. Under the FTC provision, it appears that the Item 7 line item entries are intended to combine pre-opening expenses with expenses incurred in the "initial phase" (typically the first 3 months of operation), cumulated together as a single total for each expense category. The FTC discussion of revised Item 7 (but not the actual text of the Item) expresses the Commission's position that, "these disclosures assist prospective Franchisees to understand not only the costs of entering into the business, but their likely operational cost until they break even...".

This FTC comment is disconcerting because it appears to make an important, and probably largely erroneous, assumption. First, it seems to assume that a Franchisee will break even within an initial phase in period. Second, it takes the Franchisor down a path towards an unintended earnings claim if 'break even' is the Commission's disclosure objective. Contrast the FTC's discussion on this Item with the North American Securities Administrators Association ("NASAA") Commentary on the current UFOC requirements. The current NASAA Commentary states that 'only the initial funds line is covered by the 'initial phase' requirements' and cautions against avoiding earnings claims problems in the tabulation of the chart.

An easy prediction is that many parties, including our firm, will offer comments on the proposed Item 7. Hopefully these comments will result in the clarification that the franchise community requires in this important area.

#### **Item 8 – Restrictions on Sources of Products and Services.**

There appear to be no major changes from the UFOC's current Item 8. Changes in the Proposed Rule principally create drafting nuances, including the requirements that the Franchisor disclose its criteria for evaluating proposed alternative suppliers and describe whether Franchisees are permitted to contract with alternative suppliers who meet the Franchisor's criteria. From a practical standpoint, the changes to this Item are unlikely to impact operations or approved supplier processes. However, Disclosure Document drafters will need to be mindful of the increased disclosure obligation.

#### **Item 9 – Franchisee's Obligations.**

The provisions are essentially identical to existing Item 9.

#### **Item 10 – Financing.**

The disclosures under the Proposed Rule are largely identical to the current UFOC requirements.

#### **Item 11 – Franchisor's Assistance, Advertising, Computer Systems and Training.**

The proposed Item 11 is largely identical in text to the present UFOC requirements. However, this Item is likely to be among those most impacted by the section of the Proposed Rule {436.6(c)} that

precludes the delivery of information not required by the Rule, which section is described more generally, below. Suffice it to say that many Franchisors have used this Item in the past to deliver information on programs to which they were not contractually obligated, but which were of relevance to the prospective Franchisee. Their continuing ability to do so is challenged under the above-described section.

### **Item 12 – Territory.**

Essentially the same (although sub-items are rearranged) as the current UFOC, but note that the Proposed Rule requires specific mandatory language if the Franchisor does not award exclusive territories. The term “exclusive” is not defined.

The actual required statement is that, “You will not receive an exclusive territory. (Franchisor) may establish other franchised or Franchisor-owned outlets that may compete with your location.”

Perhaps simple on its face, the combination of these statements is rife with potential issues. If a Franchisor can compete under the brand via sales through the Internet, direct mail, or some other means in a Franchisee’s territory, does the Franchisee have an ‘exclusive’ territory? What if the Franchisor reserves the right to Internet sales, but not the right to open or franchise ‘outlets’ in the territory? The variations on this theme are extensive. It would seem that the accuracy of the disclosure would be better served by allowing the Franchisor to respond to the Item requirements and to accurately describe any reservation of rights, without the mandate of a prescribed text in this area.

### **Item 13 – Trademarks.**

The slightly revised provisions of this Item conform to a disclosure that may have been common practice for many years. Specifically, the Disclosure Document is now required to state the Franchisee’s rights if he/she is required to modify or discontinue use of a trademark under any circumstance, regardless of the impetus for the change. Under the UFOC, the required disclosure covers only changes related to litigation or settlement agreements.

### **Item 14 – Patents, Copyrights and Proprietary Information.**

This Item is essentially the same as the current UFOC, but Franchisors should be aware that under the Proposed Rule they must disclose the terms of use of any proprietary information. So, for



example, if the Franchisor claimed proprietary rights in its system manuals, then the terms of their use would be described in this section. This would apply regardless of whether or not a copyright had been registered with the Copyright Office.

### **Item 15 – Obligation to Participate in the Actual Operation of the Business.**

The FTC discussion of this Section indicates that it is intended to be identical to the current UFOC Item 15. This comment leads us to conclude that the modifications in the text, and their related consequences, likely were unintended and may be eliminated in the upcoming release.

The modifications to this Section result in differing disclosures, depending upon whether or not the Franchisee is an individual or a business entity. Of course, at the time of preparing a Disclosure Document, the Franchisor cannot know who will be receiving it, and presumably would provide both disclosures.

More perplexing is the elimination of the current UFOC Item 15 requirement that provides for the disclosure of all agreements relating to the franchise that are binding on the owners (e.g., a shareholders guarantee agreement).

Again, this is an area where comment and clarification will be appropriate.

### **Item 16 – Restrictions on What the Franchisee May Sell.**

This Section is essentially the same as the old Item 16.

### **Item 17 – Renewal, Termination, Transfer and Dispute Resolution.**

This Section is substantively identical to current requirements. As such, it retains the chart that requires reference to sections of the franchise agreement relating to common provisions, including among them a reference to any integration/merger clause (those portions of Franchise Agreements that state that the written contract is the whole deal and will not be supplemented by claims of oral promises, etc.)

While the Proposed Rule does not modify this approach, the FTC uses the discussion portion of this Item to explore its concerns regarding

certain uses of such integration clauses. Under the Proposed Rule, Franchisors are prohibited from using integration clauses to disclaim liability for statements made in their Disclosure Documents. This is not a surprising position for the FTC to assume, but it does make careful drafting of Disclosure Documents even more important as the Proposed Rule takes effect.

### **Item 18 – Public Figures.**

There are no significant business changes to the old Item 18.

### **Item 19 – Financial Performance Representations (previously referenced as “Earnings Claims”).**

Four major changes are involved in this Item under the Proposed Rule:

First, to address issues of some Franchisors claiming that they are not allowed by law to make Item 19 earnings claims, all Franchisors will be required to include specific language stating that the law permits them to deliver financial performance information if they conform to Rule requirements.

Second, if a Franchisor chooses not to provide financial information (like the majority of Franchisors), it will be required to include an additional mandatory statement regarding unauthorized financial performance representations.

Third, Franchisors will be expressly allowed to provide historical financial performance information with regard to subsets of the franchise system (units open one year or more, company-owned units, kiosk units, etc.) if they make required disclosures regarding the number and percentage of outlets that achieved the stated results within the subset. This may be the most significant change in Item 19 from a marketing standpoint. However, its usefulness may be curbed by the fourth modification, described below.

Fourth, substantiating data for reported historical financial performance will have to be prepared in accordance with generally accepted accounting principles (GAAP.) This provision is likely to prove counterproductive to the FTC’s expressed intention to promote disclosure of financial performance information. It will probably have the practical result of limiting use of Franchisee figures, since the Franchisor is unlikely to be in a position to know if Franchisee data is prepared according to GAAP rules. It also raises issues for a foreign Franchisee.

system coming to the United States with operating numbers that are understandably not prepared in accordance with U.S. GAAP. Industry members have observed that the imposition of such a hurdle on inbound franchise systems under this Item and Item 21 may have unintended results for U.S. systems involved in international expansion. If other countries follow the U.S. lead, the designated accounting standards requirements may prove an operational impediment (e.g., U.S. Franchisors entering the Australian market may be required under Australian law to substantiate that numbers have been prepared in accordance with Australian GAAP).

### **Item 20 – Outlets and Franchisee Information (Formerly, “List of Outlets”).**

Three significant changes are made in this item:

First, so as to address a “double counting” problem in the Item 20 tables (a Franchise is transferred in January and terminated in December), only the first event in the year will be reported. The double counting issue is one that has long been a candidate for change, given the distortion in system numbers that it can create. However, the wisdom of choosing to ‘count’ the first event (as opposed to the last, which at least better reflects the current system status) is unclear and may be subject to change. From a business standpoint, a significant issue may be presented in the three year range displayed under the chart. Will the Franchisor have to go back and look at all closures, transfers, non renewals, etc. over the past three years and recalculate its reported figures based on this new counting system? This is an area where comment may be helpful in fashioning a phased-in reporting requirement to avoid this potential administrative burden.

Second, if Franchisors include provisions in agreements (most typically in settlement or termination agreements) that obligate Franchisees not to disclose information regarding franchise-related experiences (e.g., settlement terms, disputed issues, system information, etc.), then they will be required to disclose the existence of such provisions. These terms are described as “gag clauses” and the FTC discussion on this topic adds, “a Franchisor should be able to clarify any disclosures about gag clauses with additional, truthful information that puts the use of gag clauses into a proper context.”

Third, and perhaps most important, a Franchisor will have to provide the name, address and telephone number for each Franchisee association specific to its franchise system, if the association has been created, supported or recognized by the Franchisor, or if the association

is incorporated and asks to be included in the Disclosure Document. Any such request must be renewed on an annual basis.

### **Item 21 – Financial Statements.**

The most important change in Item 21 is the new requirement that a Franchisor must include in the Disclosure Document separate audited financial statements for a company that controls 80% or more of the Franchisor. Also, such statements must be prepared in accordance with U. S. GAAP.

This requirement may pose significant difficulties and cause substantial expense for “parent” companies which do not currently have three years of audited financials, or which are foreign-based and have financials prepared only under other countries’ auditing standards. While the problem of foreign financials may be eventually reconciled through a continuing process of matching accounting standards among accounting standards bodies in the developed world, that process will take some time. In any event, many “parent” companies do not have audited financials and the costs of preparation may be substantial. Under the UFOC, audited affiliated company statements are permitted in lieu of Franchisor statements if the affiliate (often the parent) guarantees the performance of the Franchisor. Absent a guarantee, the requirement for such separate audited statements is at the discretion of state examiners.

Also, if financial statements for a company that controls 80% or more of the Franchisor are included in the Disclosure Document, Franchisors will have to address the issue of clarifying that their controlling company is not obligated to the Franchisee for the Franchisor’s performance (in the absence of a guarantee to that effect). To fail to make such a clarification could prove misleading to a prospective Franchisee, who might otherwise anticipate a parent backing the Franchisor’s performance.

It will also be interesting to see if “parent” companies address these issues by reorganizing “sister” corporations, or through other steps designed to minimize the burden of multiple audits.

In addition, the FTC has clarified the audited financial statement “phase-in” requirements for start up Franchisors.

### **Item 22 – Contracts.**

This Item is substantially identical to old Item 22.

**Item 23 – Receipt.**

The form of receipt is changed, since there will no longer be any requirement for disclosure at the first face-to-face meeting, and the 10 business day requirement has been changed to 14 calendar days. (See the discussion of Disclosure Document Delivery Dates, below.)

Franchisors will be required to keep copies of receipts for at least three years; counsel may urge retention at least through the life of the franchise, if not longer.

Finally, as a result of the movement to electronic disclosure (see below), the old UFOC requirements requiring two copies of the receipt to be located at the end of the document have been eliminated.

**DISCLOSURE DOCUMENT DELIVERY DATES, ELECTRONIC DISCLOSURE**

**10-day Rule/5-day Rule**

Currently, Franchisors are required to deliver a UFOC on the earlier of (a) the first “face-to-face meeting” for the purpose of discussing a possible franchise sale or (b) 10 business days prior to the Franchisee signing any binding documents or paying any sums or any other consideration.

Under the Proposed Rule, the requirement to deliver a UFOC at the first “face-to-face meeting” would be eliminated.

In addition, under the Proposed Rule, the 10 business day period would be replaced by a simpler 14 day (meaning calendar day) requirement. Note, however, that this change will not pre-empt state requirements that provide for 10 business days, which may in some cases be longer than 14 calendar days. This possible inconsistency creates a trap for the unwary and will complicate the franchise sales process unless and until the state moves to eliminate the inconsistency.

Similarly, the current FTC requirement is that a Franchisor deliver to a prospective Franchisee a copy of the Franchise Agreement and all related agreements in ready-to-sign form at least five business days prior to signing. That requirement is now changed to five calendar days.

## **Electronic Delivery of UFOC**

The Proposed Rule allows electronic delivery of the Disclosure Document via Internet, e-mail, CDs, etc., and includes detailed rules as to what a Franchisor is required to do if electronic delivery is selected. However, these rules may well be in flux due to the introduction of federal statutes applicable to electronic signatures, which have been enacted since the issuance of the Proposed Rule.

By way of note, franchising professionals differ as to the wisdom of allowing on-line access to the Disclosure Document until the proper point in the sales process. Additionally, registration states have not as yet adopted a uniform position as to electronic delivery and its related requirements. All of these factors create significant uncertainty about electronic delivery. A detailed examination of the issues is outside the scope of this paper.

## **UPDATING OF DISCLOSURE DOCUMENTS AND NEGOTIATED CHANGES.**

### **Annual Updating**

As has been the case, Franchisors are required by the Proposed Rule to update the Disclosure Document within 90 days of the end of their fiscal year.

[Paralegals and attorneys will note one open issue in this area: Technically, under the Interpretive guides for the current FTC Rule, Franchisors with a state registration, who use the same documents in non-registration states, may do their annual updating consistent with the expiration date in the registration state, which may be after the 90 day period. Guidance will be needed as to whether this approach will continue to apply under the Proposed Rule.]

### **Material Changes**

Developments such as litigation, fee modifications, personnel changes, etc., during the course of a fiscal year, may require amendment of a Disclosure Document. Under the Proposed Rule, such material changes must be incorporated in the Disclosure Document on a quarterly basis (note that franchise counsel generally recommend much more prompt amendments to UFOCs and re-delivery to prospects, in part because state laws often require more prompt updating.)

In addition, under the Proposed Rule, Franchisors will also be required to notify prospective Franchisees of any material changes as of (a) the date the Disclosure Document is delivered and (b) as of the date of signing the Franchise Agreement.

### **Negotiated Changes**

As noted above, the Proposed Rule prohibits the Franchisor from requiring the Franchisee to waive reliance on any representations made in the Disclosure Document. Apparently fearing that this provision might imply a prohibition of negotiated changes to the franchise agreement, the FTC has included a provision in the Proposed Rule that expressly allows negotiated changes if three conditions are met:

1. The Franchisor identifies the changed terms;
2. The prospective Franchisee initials the changes; and
3. The prospective Franchisee is given five days to review the changes before signing or paying any money.

From an administrative standpoint, substantial revisions in a document could require careful attention to detail to ensure that the finally executed document meets the prescribed requirements.

### **Other Notes**

As previously noted, the Proposed Rule prohibits the inclusion of unprescribed information in the Disclosure Document unless otherwise mandated by state law. The practical consequence of this provision is uncertain. Many Franchisors have developed UFOCs that may go beyond the technical requirements of the guidelines in an effort to better describe their policies, systems, current programs and business philosophies to a prospective Franchisee. If this provision is not qualified or clarified, the result may be documents that are technically accurate, but lacking in potentially valuable information about the Franchisor and its system.

While a phase-in period for any new Rule will be required, the duration of such a period is up in the air. Hopefully, the FTC will allow sufficient time for registration states to respond to the new provisions and to eliminate certain of the inconsistencies between the new Rule and long standing state laws/regulations that will inevitably result.

