THE AMENDED FTC FRANCHISE RULE: FIVE YEARS LATER

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THE AMENDED FRANCHISE RULE: FIVE YEARS LATER

I. INTRODUCTION

This paper is a review of the history of the Federal Trade Commission’s Franchise Rule, the recent amendments to the Rule, commentary on whether the Rule is serving its purpose and some proposals for updating and revamping the Rule.¹

II. HISTORY OF THE FRANCHISE RULE

As most franchise practitioners know, 2007 was a watershed year for the FTC and the franchise community. It was then that the agency formally published its long-awaited amended franchise rule (“Amended Rule”) in the Federal Register.² More than ten years in the making, after innumerable rounds of public comment and testimony from interested parties at workshops addressing key issues,³ the Amended Rule sought to harmonize federal and state pre-sale disclosure requirements in the interest of greater uniformity.

Five years after the Amended Rule took final effect on July 1, 2008, it is now fair to ask whether, after such a long gestation, the FTC gave birth to an elephant or a mouse. Has the Amended Rule made any real difference, other than to create a less risqué acronym for the disclosure document? Has it contributed to any improvement at all in regulatory uniformity? Have its new provisions (e.g., on electronic disclosures and financial performance representations) helped or hurt franchise purchasers? What further improvements are still needed?

A. Why the Original Rule Did Not Create a Uniform Disclosure Standard

The Original Rule, issued in 1978 after nine years of similar rounds of public comment, workshops and deliberation,⁴ created a minimum national standard for pre-sale franchise disclosures. Two developments during the rulemaking process, however, conspired to prevent the Original Rule from also establishing a uniform nationwide norm for franchise disclosures.

The first, oddly enough, was enactment in 1975 of the Magnuson-Moss Warranty -- FTC Improvement Act, which, in addition to its landmark warranty requirements for consumer goods, created detailed and time-consuming new requirements applicable to any subsequent FTC rulemaking.⁵ The only exception was a “grandfathering” provision allowing the FTC to issue any

¹ This paper represents the collective work of the authors. However, given the nature of the topic and its treatment, as well as the requirement that the topic be analyzed in a unified paper, any views herein do not necessarily represent the individual views of the authors. In particular, note that Section III is primarily Dennis Wieczorek’s work product and Sections IV and V are primarily Howard Bundy’s work product.


proposed but not yet final rule “with respect to which presentation of data, views, and arguments was substantially completed” when the law took effect. Not surprisingly, the FTC elected to proceed with its existing franchise rulemaking, rather than restart it under the new requirements, but this decision ultimately prevented the agency from harmonizing its franchise rule with emerging state law.

The second development was the relatively rapid enactment during the 1970’s of a number of state franchise registration and disclosure laws, no two of which contained identical disclosure provisions. Faced with preparing separate disclosure documents for each state to comply with this hodgepodge of requirements, some franchise practitioners beseeched the FTC to adopt a franchise rule that would preempt state law, but were ultimately unsuccessful. Others worked with regulators responsible for administering the new state laws to create a single uniform disclosure format containing the greatest disclosure required by any one state law that each of the registration states could accept for its required filing. Their joint efforts produced the well-known Uniform Franchise Offering Circular (“UFOC”) disclosure format.

By the time the FTC issued the Original Rule in 1978, the UFOC had already rapidly become the preferred disclosure format for franchisors, particularly for those wishing to sell franchises in major franchise markets with state registration requirements such as California, Illinois and, later, New York. Constrained by the “grandfathering” clause of the Magnuson-Moss Act, the FTC was not free to substitute the UFOC disclosure requirements for the rule provisions under consideration when that statute took effect. Instead, the agency could only publish the UFOC requirements as an appendix to the statement of basis and purpose for the Original Rule and opine that because the UFOC, “viewed as a whole” provided “protection to prospective franchisees equal to or greater than that provided by [the] rule,” it could be used to comply with the federal disclosure requirement.

B. How the Amended Rule Might Lead to Greater Uniformity

With state regulators firmly in the UFOC driver’s seat, each sometimes interpreting the UFOC requirements differently, franchisors and their counsel again besieged the FTC with pleas for federal preemption and state regulators with requests for still more specific UFOC requirements in an effort to limit the discretion of state franchise examiners. Despite ongoing discussions leading to periodic revisions of the UFOC Guidelines, including a “plain English” approach.

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7 The FTC did not comply with this request both because it lacked the express statutory authority required to evince Congressional intent to authorize preemption, see Parker v. Brown, 317 U.S. 341 (1943), and because of a clear expression of congressional intent to withhold blanket preemptive authority in the legislative history of the Magnuson-Moss Act. H.R. REP. NO. 1107, 93d Cong., 2d Sess. 45 (1974). The agency cautiously pushed the envelope with its determination that the franchise rule would preempt state or local laws or regulations only to the extent that they “are inconsistent with any provision of [the rule], and then only to the extent of the inconsistency.” 16 C.F.R. Part 436, Note 2, available at 44 Fed. Reg. 49966, 49991 (Aug. 24, 1979). The Commission took pains to specify that a law or regulation “is not inconsistent with [the rule] if the protection such law or regulation affords any prospective franchisee is equal to or greater than that provided by [the rule].” Id.

8 Two days after the Commission had published a revised draft of the franchise rule for public comment, the Midwest Securities Commissioners Association adopted its final draft of the UFOC on August 24, 1974.

revision finalized in 1994, differences in interpretation from state to state and examiner to examiner persisted.

With the publication of the Amended Rule, the FTC arguably regained the disclosure leadership role it sought but forfeited with the Original Rule. Although the Amended Rule reflects no lack of collaboration between the FTC staff and state regulators, the ultimate arbiter on interpretation of its disclosure requirements is now the FTC, rather than state examiners, as the compliance guide issued by the FTC makes clear.10

As a practical matter, however, it appears that FTC staff routinely consults with state regulators before issuing new interpretive guidance as FAQs on the FTC website,11 and that issues raised by state regulators and by complaints from practitioners have prompted a number of the FAQs. In addition, FTC staff was directly involved in the Commentary the North American Securities Administrators Association (“NASAA”) prepared on the Amended Rule,12 and continues to play the same role in the preparation of additional NASAA guidance.

C. How the Amended Rule Adopts and Alters UFOC Requirements

Moreover, in amending the Original Rule to conform more closely to the UFOC, the FTC did not adopt all of the UFOC disclosure requirements lock, stock and barrel. The Amended Rule deletes the two mandatory UFOC cover page risk factor disclosures on choice of law and venue, but permits inclusion on the cover page of state mandated risk factors. The amendments also omit the former UFOC Item 2 sales broker disclosure, streamline the Item 11 computer disclosures, and modify Item 20 to eliminate inflated turnover rates.

In substituting its Franchise Disclosure Document (“FDD”) disclosures for those of the UFOC, the Amended Rule incorporates a few of the Original Rule’s requirements. Two are particularly noteworthy: parent disclosures and the audited statement phase-in. Item 1 requires disclosure of the name and principal address of any parents of the franchisor.13 Item 3 then mandates disclosure of the parent’s litigation if the parent promises to back the franchisor financially or otherwise guarantees the franchisor’s performance.14 Item 4 next specifies that a parent’s involvement in a bankruptcy must be disclosed,15 and Item 21 requires inclusion in the FDD of the parent’s financial statements if it commits to perform post-sale obligations or


13 16 C.F.R. § 436.5(a)(1). FAQ 16 clarifies that not every parent entity in the chain of ownership of the franchisor need be disclosed, but only those parents “that in fact exercise control over the policies and direction of the franchise system.”

14 16 C.F.R. § 436.5(c)(1). FAQ 16 explains that “financial backing” refers to promises to keep the franchisor financially stable, as by paying its debts to third parties or infusing cash or other assets if need. In contrast “guaranteeing performance” refers to promises to perform obligations to franchisees undertaken by the franchisor if it is unable to do so.

15 16 C.F.R. § 436.5(d)(1).
guarantees the franchisor’s performance.\textsuperscript{16} Item 21 also carries over the Original Rule’s provision allowing an audited statement phase-in period for start-up franchisors.\textsuperscript{17}

**D. New Requirements to Protect Prospective Franchisees**

The FTC also added a number of new disclosure requirements to alert potential franchisees to possible risks in the franchise relationship. Thus, Item 3 of the Amended Rule now requires summary disclosures of litigation a franchisor has brought against its franchisees in its last fiscal year.\textsuperscript{18} In addition, if a franchisor does not provide franchisees with an exclusive territory, Item 12 of the Amended Rule requires a new warning that a franchisee “may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.”\textsuperscript{19}

Item 17 similarly requires franchisors to disclose what they mean by “renewal” of the franchise, and whether a franchisee may be required to sign a new contract with materially different terms and conditions upon renewal.\textsuperscript{20} Likewise, under Item 20, if any present or former franchisee has signed a confidentiality clause during its last three fiscal years, the franchisor must warn potential purchasers that they may not be able to talk to those franchisees.\textsuperscript{21} In addition, Item 20 provides an alternate source of information by disclosing contact information for independent trademark-specific franchisee associations at their request\textsuperscript{22} as well as franchisee associations created, sponsored or endorsed by the franchisor.

**E. Updates to Address the Electronic Marketplace**

The Amended Rule includes other new disclosure provisions in response to the transformative impact of the Internet and electronic communication in the marketplace since the last UFOC revision in 1994. It updates the UFOC with new Item 11 disclosures on the use of electronic cash registers and computer systems and any independent access by the franchisor to the data generated.\textsuperscript{23} New Item 12 provisions require disclosure of restrictions preventing franchisees from making sales outside their territory via the Internet, telemarketing, catalog

\textsuperscript{16} 16 C.F.R. § 436.5(u)(1)(v).

\textsuperscript{17} 16 C.F.R. § 436.5(u)(2).

\textsuperscript{18} 16 C.F.R. § 436.5(c)(1)(ii). Although only “material” actions need be disclosed, the Statement of Basis and Purpose states that “the Commission intends the disclosure of franchisor-initiated litigation to be interpreted broadly to cover most suits,” including collection actions, that go “to the quality of the franchise relationship,” without regard to the materiality of the dollar amount at issue. 72 Fed. Reg. at 15482.

\textsuperscript{19} 16 C.F.R. § 436.5(j)(5)(i). FAQ 25 clarifies that this disclaimer may be omitted only if the franchise agreement grants a geographic area within which the franchisors agrees not to either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks or service marks.

\textsuperscript{20} 16 C.F.R. § 436.5(q)(3).

\textsuperscript{21} 16 C.F.R. § 436.5(t)(7). In addition to the prescribed disclosure language, a franchisor may state the number and percentage of its current and former franchisees that have agreed to confidentiality clauses during its past three fiscal years, but is not required to do so.

\textsuperscript{22} 16 C.F.R. § 436.6(t)(8). The association of the franchisor’s franchisees must be incorporated or otherwise organized under state law, and must renew its request for inclusion in the franchisor's FDD annually.

\textsuperscript{23} 16 C.F.R. § 436.5(k)(5).
sales or direct marketing, and provisions permitting the franchisor to make such sales to consumers within their territory.²⁴

In perhaps the most important of these marketplace updates, the Amended Rule expressly authorizes electronic delivery of the FDD via facsimile, email, and Internet website,²⁵ as well as electronic return of the electronically signed receipt provided pursuant to Item 23.²⁶ Before furnishing an FDD, franchisors must inform potential franchisees of the formats in which the FDD is available, and any prerequisites for receiving or conditions necessary for reviewing it in a particular format.²⁷ Franchisors must also provide electronic disclosures in a form permitting potential purchasers to review and retain them for future reference,²⁸ and may include scroll bars, internal links, and search features to assist in review of the FDD, but nothing else,²⁹ to ensure that potential purchasers receive a single, complete FDD.

F. New Flexibility for Financial Performance Representations

The Amended Rule updates that appear to have had the greatest marketplace impact, however, are those to Item 19. Prior to the Amended Rule, only some 20 percent of franchisors provided earnings claims in Item 19.³⁰ By all reports from state franchise regulators and practitioners, the percentage of franchisors making what are now called “financial performance representations” has at least doubled and possibly tripled since the amendments took effect, and many practitioners expect the percentage to continue to increase in the years ahead.

Although franchisee advocates argued strenuously during the rulemaking that franchisors should be required to make financial performance representations because of the importance of sales, income and profit information to prospective purchasers, the FTC ultimately proved unwilling to mandate what franchisor advocates maintained would be a potential barrier to new entrants or an incentive for creative misrepresentation. Instead, the agency modified Item 19 in four principal respects likely to encourage franchisors to provide this information voluntarily.

First, the Amended Rule requires franchisors to begin Item 19 with a prescribed preamble clearly stating that the franchise rule allows them to provide information about the financial performance of franchised or company-owned outlets.³¹ If nothing else, this

²⁵ 16 C.F.R. § 436.2(c).
²⁶ 16 C.F.R. §§ 436.1(u) (defining “signature” to include “electronic signature”), 436.5(w)(8) (contemplating return of the receipt via facsimile and email).
²⁷ 16 C.F.R. § 436.6(g). A franchisor that offers the FDD in more than one format may also insert a prescribed statement on the cover page notifying potential purchasers of the availability of the other options. 16 C.F.R. § 436.3(f).
²⁸ 16 C.F.R. § 436.6(b).
²⁹ 15 C.F.R. § 436.6(d) (specifically prohibiting the use of audio, video, animation, pop-up screens and links to external information).
³¹ 16 C.F.R. § 436.5(e)(1). If a franchisor elects not to provide financial performance information, it must add a second prescribed preamble stating that fact, and that it does not authorize its employees or representatives to do so.
requirement now puts a stop to common prior false excuses that “the FTC won’t let us give you that information,” and thus may subject franchisors to greater competitive marketplace pressure to provide financial performance information.

Second, Item 19 now provides greater flexibility than before in the kinds of claims franchisors can make. It expressly permits historical financial performance representations that are limited to subgroups of outlets “that share a particular set of characteristics.” Franchisors making subgroup claims must not only have a reasonable basis for the claim, but also disclose the total number of outlets in existence during the relevant period, the number of outlets that had the described characteristics, the number of outlets with those characteristics whose financial data was used, and the number and percent that actually attained the stated results. This new freedom to limit financial representations to meaningful subgroups should help reduce the cost of preparing such representations compared to the system-wide representations previously permitted by the UFOC.

Third, the new Item 19 expands the types of supplemental claims that franchisors may make. The UFOC has long permitted franchisors to show potential purchasers the actual operating results of an existing outlet they want to buy, and Item 19 now specifies that they may continue to do so regardless of whether they make a financial performance representations in Item 19. The Amended Rule now also allows franchisors that make a financial performance representations in Item 19 to give prospects other supplemental claims in writing pertaining to a particular type of location (e.g., suburban, rural, northeastern) or variation of the franchise (e.g., mall, kiosk).

Finally, the Amended Rule allows franchisors that do not make financial performance representations to give cost information to potential purchasers to assist them in evaluating the franchise and developing a business plan. The FTC has made it clear that the omission of any mention of “expenses” in the Amended Rule’s definition of a “financial performance representation” is intended to exclude cost information alone, from the requirements of Item 19. As the Compliance Guide emphasizes, however, any presentation of cost data together with additional sales or earnings figures from which potential purchasers could readily calculate average net profit figures, does require an Item 19 disclosure.

III. REVIEW OF CHANGES IMPLEMENTED IN THE AMENDED RULE

This section of the paper summarizes some of the more significant changes contained in the Amended Rule. It also covers developments since 2008, including the issuance of FAQs by FTC staff and the promulgation of the NASAA Commentary.

16 C.F.R. § 436.5(s)(2). FAQ 27 authorizes a similar statement for franchisors to do make a financial performance representation in Item 19, but wish to make it clear that they do not authorize any other financial performance claim.


34 16 C.F.R. § 436.5(u)(4).

35 16 C.F.R. § 436.5(u)(5).


37 Compliance Guide, supra note 9, at 131.
A. Exemptions

The definitional elements of “franchise” under the Amended Rule are virtually unchanged, but a number of exemptions have been added. These new exemptions appear to be derived from certain existing state franchise disclosure laws, specifically statutory provisions focused on the resources and experience of the prospective franchisee. Presumably the FTC concluded that sophisticated purchasers (whether based on size of investment, financial resources, specific business experience or otherwise) do not need an FDD and instead can rely on their own knowledge and skills or that of their attorneys, accountants or other professional advisors.

While these new sophisticated buyer exemptions have proven valuable to franchisors, their value is somewhat diminished by the lack of consistency with state franchise laws. In states with no such laws, a franchisor and franchisee (who fits an Amended Rule exemption) can enter into a relationship without regard for disclosure or other Amended Rule requirements. In states with franchise disclosure laws, the FTC’s sophisticated purchaser exemptions have limited value because the state laws typically require disclosure whether or not they contain comparable exemptions.

On the other hand, a number of states with franchise disclosure laws have seasoned franchisor exemptions based on the net worth of the franchisor (or its parent) and the business experience of the franchisor (or its parent). The FTC declined to include a seasoned franchisor exemption in the Amended Rule on the theory that the size or experience of the franchisor does not justify foregoing the disclosure process (after all, a large franchisor may be selling low investment franchises to inexperienced and unsophisticated franchisees).

The end result of these differences between the exemptions of the Amended Rule and the exemptions of the state franchise laws is the continuation of a patchwork quilt of varying disclosure rules from state-to-state. In some states, an exemption application must be filed (with possible regulatory review); in other states, only disclosure is required; and, in the bulk of the states, no disclosure at all is necessary.

In an attempt to harmonize disparate state exemptions, NASAA adopted Model Franchise Exemptions on September 9, 2012. It remains to be seen whether any state will adopt these exemptions.

B. Disclosures for Multi-Unit Franchise Offerings

The Amended Rule clarified the classification of certain types of multi-unit franchise offers. Among other things, there had been ongoing confusion regarding the status and role of “development agents” or “regional directors” or “area representatives” (the last of which we will use as the most prevalent label for these types of relationships). An area representative purchases from the franchisor the right to sell and service franchises in a defined geographic area. However unlike a subfranchisor, an area representative does not enter into a contractual

39 16 C.F.R. § 436.8(a)(5).
40 See, e.g., Ill. Comp. Stat. § 708/8(a).
relationship with the franchisee; instead the actual operating franchised business is based on a contract between the franchisor and franchisee. Thus, even if the area representative is heavily involved in training and providing ongoing services to franchisees, the franchisor is ultimately responsible for the performance of these obligations under the terms of the franchise agreement.

This issue was the subject of FTC FAQ #9. The FTC concluded that, unless an area representative is a party to the contract with the franchisee, an area representative will not be considered a subfranchisor. This conclusion means that information about the area representative will not be included in the FDD provided to the franchisee (other than possibly including Item 2 information on key area representative personnel). While there are some definitional variations in a few state franchise disclosure laws, most of the states have concurred in the FTC’s treatment of area representatives.

C. Delivery Rules

The Amended Rule discarded a key aspect of the Original Rule, which required delivery of the FDD at the “first personal meeting” between the parties. (On an issue of lesser importance, the FTC also abandoned a cooling off period based on a “business days” standard for one based on calendar days.) The FTC eliminated the first personal meeting disclosure requirement based on several factors: (1) there had been ongoing controversy over what constituted a “personal meeting”; (2) thanks to the internet and other means of electronic communication, franchisors were communicating earlier and more intensively with franchisees; and (3) as a result, face-to-face meetings sometimes occurred late in the franchise sales process or not at all. (Notwithstanding this change by the FTC, the New York and Rhode Island laws have not yet been amended to omit the first personal meeting standard.) The FTC concluded that delivery of the FDD to the prospect at least 14 calendar days before contract signing or payment of consideration was arguably adequate for pre-sale disclosure purposes.

However, the FTC added a new requirement which could require delivery of an FDD much earlier in the sales process. The Amended Rule mandates delivery of the FDD “on reasonable request” by the prospect. Obviously, the issue of the reasonableness of a request could be problematic, but the FTC indicated that only true prospects are legally entitled to receive a response to such a request, presumably meaning those that have completed a franchise application and thereafter have been qualified by the franchisor as suitable for acquisition of a franchise.

In addition, the FTC determined that the form franchise agreement attached to the FDD would suffice as the execution copy of such agreement and a franchisor no longer would have

42 Supra note 10.
44 16 C.F.R. § 436.2(a).
45 Ibid.
47 16 C.F.R. § 436.9(d).
48 Supra note 9.
to send an execution copy in a separate communication and wait 5 business days before signing. But this change was a Pyrrhic victory, since most agreements attached to the FDD as an exhibit omit deal-specific terms, such as territories and possibly initial and other fees. If important transaction terms are absent, the Amended Rule requires a secondary disclosure process and a 7-day cooling-off period, whereby the franchisor must provide in advance a fully-completed agreement to the prospect, lacking only a date and the prospect’s signature. But if the franchisee initiates negotiations regarding any changes to the franchise agreement, the FTC has indicated that the cooling-off period is unnecessary (although this exception probably does not obviate the need for a waiting period if key provisions of the franchise agreement attached to the FDD are not completed).

D. Updating and Redisclosure

The Amended Rule effected a change, or at least a partial change, in the timing of the annual frenzy of updating FDDs. Under the Original Rule, a franchisor had to update its FDD within 90 days after the end of its fiscal year. Because most franchisor entities have a fiscal year ending on December 31, Fed Ex and UPS backed up their trucks to franchisor loading docks on or around March 31. The Amended Rule extended the deadline for updating FDDs to 120 days after fiscal year end, but the change had less impact than anticipated due to inconsistent state laws. For example, the Hawaii law requires an annual update 90 days after year end and the Maryland regulators demand an updated unaudited financial statement if the audited statement is not filed within 90 days after year end. Other states create similar timing issues due to advance filing requirements (such as California’s automatic renewal option if a franchisor’s annual update is filed approximately 90 days after year end).

The FTC’s change from 90 to 120 days benefits franchisors in most states because franchisors often have difficulties obtaining audited financial statements within 90 days after year end. But several states with franchise disclosure laws remain problematic due to direct or indirect 90-day filing mandates. The end result is that a franchisor can: (a) stick to the 120-day update but allow its registrations to temporarily lapse in a few states; (b) use multiple forms of FDD to account for the various filing/updating deadlines; or (c) move its annual update to the old 90-day deadline (which, of course, renders ineffective the change to the 120-day deadline in the Amended Rule).

With respect to amendments, the FTC maintained its policy that FDD interim updates, if needed because of material changes, be prepared on a quarterly basis (except that modifications to Item 19 financial performance representations must be made on an immediate basis). This bright-line test has worked well but many of the states with franchise disclosure

49 Ibid.
50 16 C.F.R. § 436.2(b).
51 Ibid.
52 16 C.F.R. § 436.7(a).
55 16 C.F.R. § 436.7(b).
56 16 C.F.R. § 436.7(d).
laws have rejected the quarterly updating scenario. These states variously require that amendments be filed “promptly,”57 or “as soon as reasonably possible”58 or within 30 days after a material change occurs.59 (See also NASAA Commentary 24.1.)60 These inconsistencies have created significant problems for franchisors in determining when to actually provide updated information. In some cases, to avoid delays in various states, franchisors have prepared supplements to their FDDs and delivered same to prospects without filing amendments with the states. Those franchisors likely believe that the avoidance of fraud claims from franchisees is more important than technical compliance with state filing rules.

Another related change in the Amended Rule is the limitation on the franchisor’s obligation to provide an updated FDD. Under the Amended Rule, the franchisor is not required to furnish an updated FDD (whether an annual or quarterly update) unless the prospective franchisee requests same.61 Thus, so long as the initial FDD presented to the prospect was current at that time, a franchisor has no affirmative obligation to provide subsequent updates except as requested. It is probably fair to say that the state franchise administrators generally disagree with this provision of the Amended Rule and many franchisors have tended to adhere to the state regulatory position; i.e., a prospect will receive interim FDD updates while he/she is in the sales process/pipeline prior to closing the transaction.

E. Selected FDD Issues

In addition to the obvious change to the title of the disclosure document, from Uniform Franchise Offering Circular (UFOC) to Franchise Disclosure Document (FDD), a number of other substantive disclosure modifications were incorporated in the Amended Rule. The following is a selection of some of the more significant changes.

1. Parent Disclosures

While the Original Rule emphasized the importance of disclosures about the franchisor’s parent entities, the Amended Rule clarified and fine-tuned the parent disclosures in various Items of the FDD. In particular, FAQ 16 addressed the varying definitions of “parent” for purposes of each applicable FDD Item.

Item 1 sets the stage for the usage of “parent” in the FDD. The FTC rejected the argument that only the ultimate parent need be disclosed and instead mandated the disclosure of all parent entities, including immediate and intermediate entities. However, the FTC stated that parent status would not be based on ownership, and instead would focus on whether the parent entity “in fact exercised control over the policies and direction of the franchise system.”62 The same types of parent entities are likewise covered by the bankruptcy disclosures in Item 4.

58 See, e.g., Wash. Rev. Cod § 19.100.070(3).
59 See, e.g., Wis. Stat. § 553.31.
60 Supra note 11.
61 16 C.F.R. § 436.9(f).
62 Supra note 10.
A narrower definition of parent applies to the litigation disclosures in Item 3. Litigation against a parent must be disclosed if the parent induces franchise sales by promising to provide financial support to the franchisor. Similarly, litigation must be included if the parent induces franchise sales by guaranteeing to fulfill the franchisor’s obligations to franchisees. In these cases, the FTC concluded that parent information is essential since franchisees are relying on the parent for performance, essentially as a proxy for the franchisor.\(^63\)

Similar parameters are used in Item 21 with respect to the inclusion of parent financial statements. A parent’s statements will be required if it commits to perform post-sale obligations (not just a single, isolated obligation) for the franchisor or guarantees the franchisor’s obligations. But such a commitment or guaranty does not extend to situations where the parent’s employees provide services to franchisees without any formal commitment to do so. FAQ 4 and FAQ 30 provide further illumination on situations where the parent supplies goods or services to franchisees. If the parent assumes the franchisor’s obligation to supply franchisees, or if the parent is the sole supplier of goods or services that are essential to franchised businesses, then the parent’s financial statements must be included in the FDD.

2. **Affiliate Disclosures**

There are some similarities in the way that parents and affiliates are covered in the FDD. (Obviously, all parents are affiliates but not all affiliates are parents.) Therefore, to the extent that the FDD requires disclosures of affiliates, that would necessarily include parent entities although, as noted above, parent disclosures are specifically mandated in various FDD Items.

Unlike parent disclosures in Item 1, only very limited types of affiliates are covered in this Item; namely those that offer franchises in any line of business or that sell products or services to franchisees.\(^64\) Item 3 broadens this coverage of affiliates to make it consistent with parent disclosures in that Item. However, Item 3 also requires disclosure of affiliates who offer franchises under the franchisor’s principal trademarks/service marks, presumably to capture litigation where affiliated entities are set up to franchise in specific states or regions.\(^65\) (The foregoing requirements also apply to affiliates that are subject to governmental consent decrees.)

Item 4 has the broadest application of all: the bankruptcy history of any affiliate must be disclosed.\(^66\) Similarly, there are discrete disclosures covering affiliates involved in product sourcing in Item 8, including providing data regarding sales of products to franchisees, and affiliates that may compete with franchisees via other channels of distribution or by use of other brands.\(^67\) Like a parent, if a franchisor elects to use an affiliate’s (e.g., a sister company)

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\(^{63}\) Ibid.

\(^{64}\) 16 C.F.R. § 436.5(a)(1).

\(^{65}\) 16 C.F.R. § 436.5(c)(1).

\(^{66}\) 16 C.F.R. § 436.5(d).

\(^{67}\) 16 C.F.R. § 436.5(b).
financial statement in Item 21 of the FDD, the affiliate must guaranty the franchisor’s obligations under the franchise agreement and the guaranty must be attached to the FDD.68

Items 19 and 20 also have some relevance to disclosures about affiliates. The FTC stated in FAQ 8 that Item 19 may include information about substantially similar outlets owned or franchised by an affiliate, provided that the franchisor lacks performance data of its own.69 In a similar vein, the FTC recently issued FAQ 36 relating to affiliate-owned outlet disclosure in Item 20.70 In this FAQ, the FTC indicated that affiliate outlets must be included, even if under a different brand, as long as they are substantially similar to the franchisor’s outlets. Thus, the permissive aspect of FAQ 8 with respect to Item 19 is transformed to a mandate under Item 20. Several comments regarding these FAQs: (1) it is implicit that affiliate outlets, if using the same brand and system as the franchised outlets, are the equivalent of company-owned (or franchisor-owned) outlets; (2) the language of FAQ 8 provides needed flexibility to franchisors in creating financial performance representations in Item 19, which might involve similar affiliated outlets operating under a different brand (but based on increasingly negative comments from state examiners, however, it is questionable whether this flexibility will persist); and (3) FAQ 36 may raise more questions than it answers to the extent it demands disclosure in Item 20 of similar outlets even if they operate under a different brand name and, as a result of growing consolidation in the franchise industry, there are many examples of multi-branded families of companies operating in the same industry. Perhaps FAQ 36 will require further clarification because, as currently written, franchisors generally believe that it throws too wide a net.

3. Litigation

The Amended Rule added one major element to Item 3 – the disclosure of litigation initiated by the franchisor against franchisees relating to the franchise relationship.71 FAQ 5 provided more detail on this new requirement by confirming that the time period covered is solely the last fiscal year. In addition, no updates need be provided as the case proceeds (although the case may have to be moved to another part of Item 3 of the FDD if the franchisee asserts material counterclaims against the franchisor). And, in its annual update, a franchisor should delete the list from the prior fiscal year and substitute a new list from the most recent fiscal year.72

The Amended Rule also clarified that a franchisor can remove litigation disclosures from the FDD in certain circumstances. (Many franchisors will initially include cases out of an abundance of caution but, as they move forward, circumstances may indicate that they never were material.) These include matters where the franchisor is successful (as a result of a judicial or arbitral decision) or where the case is settled and the settlement is favorable to or is neutral vis-a-vis the franchisor.73 NASAA Commentary 3.2 covers a similar issue under Item 3 but with a certain degree of vagueness. It notes that a franchisor is “held liable” if it is “restricted

68 16 C.F.R. § 436.5(u)(1)(iii).
69 Supra note 10.
70 Ibid.
71 16 C.F.R. § 436.5(c)(1)(ii).
72 Supra note 10.
73 Supra note 1 at 99.
from enforcing its rights or must take action adverse to its interest”\textsuperscript{74}. First of all, this language can lead to a wide variety of interpretations. But also, since a settlement usually involves some degree of “give and take,” which usually means that the parties give up some of their rights, this comment might raise some concern. On the other hand, the distinction appears to be that NASAA’s views apply only to a court or arbitral judgment against a franchisor rather than a settlement scenario.

4. **Exclusive Territories**

The exclusive territory issue continues to bedevil the regulators and the franchise industry. It all begins with the FTC’s mandatory disclaimer that must be used if the franchisee does not have an exclusive territory:

“\textit{You will not receive an exclusive territory. You may face competition from other franchisees, from \textit{outlets that we own}, or from other channels of distribution or competitive brands that we control.”}

The key issue is defining “exclusivity.” In FAQ 25, the FTC indicated that the disclaimer cannot be used if the franchisor only reserves the right to use other channels of distribution (such as the internet, catalogs, etc.) or to sell through competitive brands.\textsuperscript{76} This result is a little difficult to reconcile with the actual language of the disclaimer (which refers to “other channels of distribution” and “competitive brands”). More recently, the FTC issued FAQ 37, which creates a new rule relating to non-traditional locations.\textsuperscript{77} The concept of non-traditional outlets is relatively new, and consists of a reservation by the franchisor to open new locations in venues such as airports, stadiums, hospitals, colleges and others where the outlet is patronized by a limited universe of customers. These types of outlets would be treated as an exception to any exclusivity granted to the franchisee. Because these are “brick and mortar” locations within a franchisee’s “exclusive” territory, FAQ 37 requires the use of the disclaimer cited above as a warning to the franchisee that its territory isn’t as exclusive as it thinks. Notwithstanding these FAQs, one wonders why there is so much sound and fury regarding the disclaimer. Since it is extremely rare that any territory is truly an airtight exclusive territory, why not use the disclaimer in all cases other than those rare exceptions?

5. **Financial Performance Representations**

In various respects, the Amended Rule further liberalized the rules regarding financial performance representations (formerly known as “earnings claims”). Although market forces may have been the leading cause, there has been a dramatic upswing in the number of FDDs that contain a financial performance representation since the promulgation of the Amended Rule (reports indicate at least a majority of FDDs contain such representations). While there were calls for the FTC to make financial performance representations mandatory, the FTC refused to accede to those requests but that did not deter franchisors from voluntarily adding such information in Item 19 of their FDDs.

\textsuperscript{74} Supra note 11.

\textsuperscript{75} 16 C.F.R. § 436.5(e)(5)(i).

\textsuperscript{76} Supra note 10.

\textsuperscript{77} Ibid.
In addition, the Amended Rule completely contradicted the existing UFOC Guidelines by stating that cost data did not constitute a financial performance representation.\textsuperscript{78} Thus, a franchisor could provide information to prospective franchisees on labor costs, cost of goods sold, property rents and other expenses to prospective franchisees outside the strictures of Item 19 (after all, some of this data was already provided indirectly in Item 7 of the FDD). But, as the FTC giveth, it also taketh away; while a franchisor is permitted to provide dollar amount cost information, it cannot disclose costs as a percentage of revenues since the latter would potentially allow the prospect to calculate a top-line revenue number.\textsuperscript{79} NASAA Commentary 19.1 reaches a similar conclusion.\textsuperscript{80} So this aspect of liberalization had a very limited impact.

In subsequent years, the FTC fine-tuned several elements of Item 19. In FAQ 33, the FTC clarified that a financial performance representation must be contained in Item 19 in the body of the FDD, and not in an attachment to the FDD. In addition, the FTC responded to questions regarding disclaimers to be added to Item 19.\textsuperscript{81} In FAQ 27, the FTC acknowledged industry practice of including language in Item 19 alerting prospective franchisees that no financial performance representations, other than those in Item 19, were authorized by the franchisor and that management and government regulators should be contacted if any employee goes beyond the boundaries of Item 19.\textsuperscript{82}

6. Outlet Statistics

Item 20 was substantially overhauled in the Amended Rule. Without detailing all of the tables that are the key components of Item 20, the FTC intended that the tables closely track the inflow and outflow of outlets in a franchise system. For example, a franchisor should be able to reconcile the results in Tables 3 (covering franchised outlets) and 4 (covering company-owned outlets) with the overall summary in Table 1. Table 2 (covering transfers) and Table 5 (covering projections of outlets to be opened in the coming year) stand alone but provide confirmatory data on whether the system is growing and the extent of transfers among franchisees. The tabulation methods used are intended to avoid double-counting so theoretically the tables should accurately reflect the status of the system.

The FTC added a number of other disclosures to Item 20, including the following: (1) if the franchisor is selling a company-owned outlet that was previously franchised, it must provide the ownership history over the last 5 years and the reasons for the various transitions during that period;\textsuperscript{83} (2) to alert prospects that not all franchisees are able to speak to them, the franchisor must indicate whether it has imposed confidentiality agreements on current or former franchisees and, if so, specific language must be inserted in Item 20;\textsuperscript{84} (3) a warning to franchisees that their contact information may be available to third parties after they leave the

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\textsuperscript{78} Supra note 36.

\textsuperscript{79} Ibid.

\textsuperscript{80} Supra note 11.

\textsuperscript{81} Supra note 10.

\textsuperscript{82} Ibid.

\textsuperscript{83} 16 C.F.R. § 436.5(t)(6).

\textsuperscript{84} 16 C.F.R. § 436.5(t)(7).
system;\textsuperscript{85} and (4) information about independent franchisee associations, but the relevant association must request its inclusion in the FDD on an annual basis.\textsuperscript{86}

The FTC and NASAA elucidated on several aspects of Item 20 in FAQs. FAQ 19 requires the disclosure of a franchisee’s name and city and state if an agreement has been signed but an outlet is not yet open. More detailed information, such as a home telephone number or email address, is required for a former franchisee that never opened an outlet.\textsuperscript{87} NASAA Commentary 20.1 indicates that a franchisee that never opened an outlet should appear on the list of terminated franchisees but otherwise should not be included in any of the Item 20 charts.\textsuperscript{88} FAQ 28 allows the use of an attachment to list former franchisee contact information, as long as Item 20 discloses the number of former franchisees on the list that is attached. In addition, Item 20 itself and the attached list must contain the required caution: “If you buy this franchise, your contact information may be disclosed to other buyers when you leave the franchise system.”\textsuperscript{89}

NASAA added a number of other comments on Item 20, including Commentaries 20.2 and 20.3, which expressly exclude area developers and area representatives from coverage in the charts or lists.\textsuperscript{90} In addition, Commentary 20.6 clarifies that the disclosure of franchisee associations in Item 20 does not include local advertising councils or cooperatives, although Item 11 may require general disclosures about such organizations.\textsuperscript{91} Finally, NASAA Commentary 20.12 allows, but does not require, the inclusion of international outlets in Item 20.\textsuperscript{92}

7. **Financial Statements**

The Amended Rule changed little with respect to the financial statements that must be included in the FDD. Since promulgation, however, the FTC has fine-tuned several aspects of Item 21.

With respect to subfranchise offerings, it has always been the case that the relevant FDD would include financial statements for the franchisor and the subfranchisor. Because the FTC has determined that an area representative is not a subfranchisor (as described earlier in this paper), there is no need for an area representative to prepare financial statements for use in an FDD.

\textsuperscript{85} 16 C.F.R. § 436.5(t)(5).
\textsuperscript{86} 16 C.F.R. § 436.5(t)(8).
\textsuperscript{87} Supra note 10.
\textsuperscript{88} Supra note 11.
\textsuperscript{89} Supra note 82.
\textsuperscript{90} Supra note 11.
\textsuperscript{91} Ibid.
\textsuperscript{92} Ibid.
The FTC indicated in the Amended Rule that all financial statements included in an FDD must be prepared in accordance with Generally Accepted Accounting Principles (GAAP). While this is an unexceptional pronouncement, there are some issues with GAAP as it is applied in special situations. For example, foreign franchisors must reconcile their statements with U.S. GAAP, which may differ from the accounting principles in their home country (although this issue may be obviated if a U.S. franchising subsidiary is established and it prepares its own statements). The Amended Rule also contains provisions to account for the evolution of U.S. accounting principles, for example if U.S. GAAP is abandoned for International Financial Reporting Standards (IFRS).

The FTC also continued its policy permitting the phase-in of audited financial statements. While the phase-in is not permitted in all franchise disclosure states, it remains a useful tool. (As an alternative, many new franchising entities will prepare an opening audited balance sheet which typically is inexpensive and quickly prepared and which eliminates the need for the phase-in option.) As previously indicated, the Amended Rule mandates that all statements including unaudited compilations, be prepared in accordance with GAAP. There is an inherent conflict in this position because unaudited statements, which may be used under the phase-in policy and more frequently on an interim basis when an audit is stale, rarely conform to GAAP. The FTC recognized this issue in FAQ 11, where it opined that a franchisor has some flexibility with respect to preparation of an unaudited balance sheet. First, it recognized that an unaudited statement may be prepared internally rather than by an outside CPA. In addition, the FTC acknowledged that there is “flexibility in preparing such statements.” Accordingly, the FAQ stated that a franchisor should use GAAP as a guideline and that the format of the unaudited statements should conform as much as possible to the format of audited statements. In short, unaudited statements must look like GAAP statements but they do not have to literally conform to GAAP.

8. Receipts

For such a short document, the Item 23 receipt has engendered more than its share of commentary. The receipt is intended to serve two primary purposes: confirm that the FDD has been received by the prospect and provide additional notice to the prospect that he/she should hold the FDD for at least 14 days before making a binding commitment.

First, questions have been raised regarding the use of an electronic rather than a hard copy receipt. FAQ 15 contains a variety of alternatives but basically reinforces the FTC’s philosophy that electronic disclosure, along with electronic proof of delivery, is an acceptable and perhaps a preferable methodology. FAQ 15 permits the use of an external receipt webpage even though the Amended Rule prohibits the use of external links. In this case, the FTC determined that the external webpage was acceptable because it had no content other than a copy of the receipt itself and was accessible only from Item 23 of the electronic FDD. The FTC also permits the use of an icon on the electronic FDD that would allow printing of the

93 16 C.F.R. § 436.5(u)(1).
94 Ibid.
95 16 C.F.R. § 436.5(u)(2).
96 Supra note 10.
97 Supra note 10.
receipt. However, the FTC rejected a proposal that would separate the FDD from the receipt, thereby requiring creation of two electronic documents, on the grounds that there would be no proof that the FDD had ever been opened.

A more interesting issue arises from the listing of franchise sellers on the receipt page. “Franchise seller” is defined as “a person who offers for sale, sells or arranges for the sale of a franchise” and it includes franchisor employees and third parties such as brokers. Because franchise seller information must be included on the receipt, questions have arisen as to the types and number of people that should be listed. FAQ 12 addressed some of these issues and noted that the list is necessary to enable the prospect to refer to a point of contact and to identify responsible parties to government regulators. Among other things, if a person receives a commission or some other selling credit, that person should be listed as a franchise seller. On the other hand, the FAQ warns against listing every possible person that may have contact with the prospective franchisee. Similarly, the name of the franchise seller may not be known at the time the FDD is received by the prospect so it is permissible to add a name later (and another copy of the receipt sent to the prospect) even if the receipt has already been signed.

FAQ 23 provided further detail on the franchise seller listing requirement, focusing on the need to add to or revise the names of franchise sellers as the deal progresses. With the caveat that the receipt should list only those with whom the prospect had significant contact, the FTC acknowledged that the receipt page may have to be supplemented with additional names before the transaction closes. And, while the franchisor may seek assistance from the prospect in identifying the people with whom he/she had significant interaction, in the end the burden of properly listing all franchise sellers rests with the franchisor.

One of the problems with this issue is that a prospective franchisee may have extensive interaction with multiple franchisor personnel or brokers during the sales process. For example, senior franchisor executives may spend multiple hours with a prospect during a “Discovery Day” or in subsequent conversations and that may mean five to ten or more department heads. Are all of them franchise sellers? It probably makes sense to list the names of the members of the franchise sales department, including the principal sales person shepherding the transaction, on the receipt, along with one or more blanks for other heavily involved personnel. As a practical matter, if the number of names exceeds five or so, a franchisor is likely being over-inclusive.

IV. DOES THE FDD WORK?

A. The Look and Feel

Consistent with the FTC’s efforts to minimize the changes from the Uniform Franchise Offering Circular to the Franchise Disclosure Document, the look and feel of the FDD has not materially changed since the 1970s. It remains, in most cases dense blocks of legalese printed in black ink on white paper, or the digital equivalent—PDF and in most cases it only gets updated once a year. It was more than a quarter of a century ago when the FTC began its review of the FTC Franchise Rule and when the foundational decisions resulting in the Amended Rule were made.

98 Ibid.
99 Ibid.
Meanwhile, the way people communicate has changed dramatically. Time and Newsweek with their multi-page, densely written articles have essentially disappeared in favor of MSNBC and FOX with their 200 to 1000 word articles with photographs and video. Long letters to friends and families have disappeared in favor of short Facebook or Twitter posts. Long, complex speeches have been largely replaced by a few key bullets on a dozen PowerPoint slides. “Software manuals” have disappeared. We no longer have a large stack of books, magazines and newspapers waiting on the table in the living room or at the bedside. Instead, we pick up a small digital device wherever we are and access the information we need right then. The information we get and rely upon is current—usually up to the second. Anything published more than a few hours ago is presumed out of date and largely irrelevant.

It is probably axiomatic that the original purpose of the FDD is to communicate important information to prospective investors. We posit the question of whether the current format of the FDD is communicating anything given the anecdotal evidence of how few prospective franchisees actually read it, much less understand it. If Marshal McLuhan was right that “the medium is the message”\(^\text{100}\), is it possible that the medium—the media and format (look and feel) of the FDD is obscuring the message that prospective franchisees need to get?

It has long been a rule of legal drafting that, if you want a customer or other party to sign a document without reading or understanding it, you make it long and dense and with as many cross references and remotely located definitions as possible. Unfortunately, that rule has been carried over into the drafting of FDDs. They are difficult for most lawyers to read and understand—much less a franchisee trying to go it alone.

Almost 20 years ago, the software community realized that no one ever read their detailed (and often very useful) software manuals. Interactive online “help” menus probably is not the answer for franchising, but could there be an equivalent way to improve the method of delivery?

Today, prospective franchisees have essentially two mediums for obtaining information about a franchise they are considering. One is a colorful, interactive and entertaining web site designed by skilled marketers and communicators; the other is a bland, dense, black on white, legal document written by lawyers (if the prospect is lucky). One allows the franchisee to obtain information in plain, simple English; the other requires strenuous mental lifting. Is it any wonder that franchisees don’t read and understand the current FDD?

This paper does not propose a specific alternative format, but merely raises the question of whether it is time for the franchise community (government regulators, franchisors, franchisees and franchise lawyers) to have a thoughtful conversation about whether it would improve communication if we massaged the medium. Is it time to modernize the medium while insuring that prospective franchisees receive the information they need to make an informed investment decision?

Even if the medium cannot change, would it be more readable if certain portions of the FDD were in a uniform outline format giving franchisees the ability to absorb information in smaller pieces? What about re-labeling some of the “Items” to get rid of the somewhat archaic and wonky labels? The franchise community is full of creativity and good communicators who should be able to come up with an updated means of communication.

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\(^{100}\) Marshall McLuhan, The Medium is the Massage: An Inventory of Effects, Bantam 1967.
In addition, are CDs, DVDs, thumb drives (and other similarly portable electronic media) an effective and reliable means of providing the FDD to prospective franchisees? The FTC rule requires that the FDD be delivered as a single discrete document. The idea of the rule is to prevent franchisors and their franchise sellers from burying the disclosure document in a thick packet of colorful sales material. In the face of recent anecdotal reports of franchisees attending a “discovery day” and being given a large folder of information—with the FDD tucked away in the back of the folder on a CD, one must ask whether that comports with the spirit of the rule. Further, one must ask whether such ease of burying the disclosures in a sea of information means that such delivery on portable electronic media should be restricted. Should there be an express prohibition on delivery within a packet of other documents? Should there be a requirement for some additional receipt language that calls the prospect’s attention to the portable electronic media? Should delivery by portable electronic media be prohibited entirely?

B. Are the Item Topics Relevant?

For over 40 years, the franchise community has blindly assumed that the current list of 23 “Items” is the best breakdown of the information that is relevant to every prospective franchisee. Is that paradigm still correct? Are there additional topics as to which franchisees need information? Are there topics that have become irrelevant—or not important enough to justify a full Item? Have some Items swollen to the point where they should be broken up to make important information more accessible?

1. Are There Additional Topics On Which Franchisees Need Information?

Are there really additional categories of information that would be valuable to franchisees? Although the ultimate answer should be a collective effort, the following list can be used to start the conversation:

- Detail regarding the competitive circumstances of the franchise within the relevant industry;
- The existence of impound/escrow orders or of fee deferral arrangements;
- If a parent or affiliate of the franchisor includes its financial statements, that parent or affiliate is unconditionally guaranteeing the accuracy of the FDD and full performance of the franchise agreement;
- The franchisee will not be bound by any term of any operations manual or other outside document to the extent it is inconsistent with or imposes requirements or restrictions greater than those contained in the franchise agreement unless the full document is included in the FDD;
- Full P&L information, by major category, presented as high/low/average, regarding the financial performance of the franchisor’s units and of its franchisees’ units if the franchisor collects or has the right to collect such information and the units on which the information is based have been in operation for twelve months or more;
- Full P&L information, by major category, presented as high/low/average, regarding the financial performance of the franchisor’s units and of its franchisees’ units if the franchisor collects or has the right to collect such information and the units on which the information is based have been in operation for twelve months or more. The information would be presented for each of the first three years of operation for each unit.
Disclosure of the shortest, longest and average times for existing units (company owned and franchised) to break even. Define break even. State specifically whether break even includes: (a) fair market compensation for the franchisee; and (b) a return on total capital invested.

Identification of third party obligations normally requiring a personal guarantee of the franchisee.

Total estimated amount as of the opening of the franchise of all future payments to third parties expected to be personally guaranteed by the franchisee.

A clear statement of the consequences to the franchisee of signing personal guarantees to third parties should the business not perform as expected (personal bankruptcy).

Description of other business models the franchisor offers;

Description of the relationship between the franchisor and any intermediary (sub-franchisor, area developer, master developer, etc.);

Description of the relationship between the franchisee and any intermediary, including what happens if the intermediary fails to perform;

Whether employees are required to sign non-compete or other agreements and the consequences if an employee refuses to sign or fails to sign before commencing employment;

Whether class or group dispute resolution is prohibited or permitted.

Rights and obligations of the franchisee relating to collection, ownership and protection of customer data;

The franchisor's ability to control gross profit margins through the combination of controlling advertising content, internet marketing and communications channels, “national account” pricing and terms, sourcing controls (proprietary and non-proprietary products and services), and control over rebates, discounts and allowances from vendors.

2. Are There Topics That Have Become Irrelevant Or Not Deserving Of Marquee Treatment?

Are there existing categories of information that have evolved to have minimal relevance to franchisees? Although the ultimate answer should be a collective effort, the following list is provided to start the conversation:

- Current Items 5 and 6. Fees are fees. Could they be combined into a single item entitled “Franchise Fees” with two categories: fees you pay to us before you open your business; and fees you pay to us after you open your business?
- Current Item 9. Franchisors don't understand it. Franchisees don't understand it or use it. Could it be replaced by simply requiring a detailed table of contents on the franchise agreement? Keep in mind that the franchise agreement is a mandatory element of the FDD.
- Current Items 13 and 14. Could these items be replaced with a single Item entitled “Our Intellectual Property” with 4 categories: (a) trademarks; (b) patents and copyrights; (c) trade secrets; and (d) proprietary information?
- Current Item 18. Disclosures of public figures are very rare. Few understand what it means. It consumes valuable white space in the FDD. Could it not be incorporated in what is now Item 1? In those rare situations where it arises, it can be important information. The rest of the time the current disclaimer would
take only a sentence in Item 1. When it does arise, perhaps a clearer definition of “public figure” might help.

3. **Could The Current Organization Of The FDD Be Improved?**

The current organization of the 23 items has been in place, with only minor incremental changes, for over 40 years. Under the current structure, information about the franchisor and the franchise being offered is co-mingled and spread through at least Items 1, 2, 3, 4, 8, 9, 11, 15 & 16. Financial information is spread through Items 5, 6, 7, 10, and 19. Would it be possible to improve readability, understandability and access to information by revising the structure? Although the ultimate answer should be a collective effort, the following is one possible structure to start the conversation—this attempt is to organize the information by functional category with related information together:

1. Information about the franchisor
   a. Identification of franchisor, parents, predecessors & affiliates
   b. Nature of business of franchisor, parents, predecessors & affiliates
   c. Prior business experience of franchisor etc.
   d. Public figures
2. Information about the franchise offered
   a. Description of the business offered
      i. Products & services
      ii. Market for products & services
      iii. Laws relating to the business
   b. Competition you will face
      i. From us
      ii. Identification of principal competitors
      iii. Our market share
      iv. How our products and services are distinguished
   c. Territory rights & limitations
   d. Obligations relating to obtaining a required site
3. Your investment
   a. Initial Fees
   b. Other Fees
   c. Estimated Initial Investment
   d. Total guaranteed obligations
   e. Financing
4. Your potential profits (current Item 19)
5. Obligations of the franchisor
   a. Escrow/impound/defer
   b. Pre-opening training
   c. Site selection & legal compliance
   d. Site review & approval
   e. Site development
   f. Post-opening training
   g. Post-opening support
   h. Research & development
   i. Equipment and fixtures
   j. Delivery & installation
   k. Inventory
   l. Advertising & marketing
m. Reports to franchisees

6. Your operational obligations
   a. Pre-opening training
   b. Post-opening training
   c. Site selection & legal compliance
   d. Site development
   e. Equipment & fixtures
      i. Original
      ii. Replace, maintain, repair
      iii. New categories
   f. Employees
   g. Inventory
   h. Advertising & marketing
      i. National marketing
      ii. Regional marketing cooperatives
      iii. Local marketing
   i. Reports & information
   j. Access to computers & data
   k. Collection, storage, ownership of customer data

7. Franchisor's Intellectual Property
   a. Trademarks
   b. Patents & Copyrights
   c. Trade secrets
   d. Proprietary information

8. Miscellaneous matters (current Item 17)
   a. Termination
   b. Dispute resolution
   c. Etc.

9. Outlets and Franchisee Information (current Item 20)

10. Financial Statements

11. Contracts

12. Receipts

The foregoing structure is not offered as the ultimate answer—but only to demonstrate that it is possible to develop and articulate a different structure that might better group related information together and improve the quality of disclosure overall. Perhaps, through the discussion, someone can propose a different and better organization for this important information.

4. Would A Cover Sheet Or A Separate Summary Of Key Information Help?

Various proposals have been floated for a one or two page cover sheet for the FDD or even a separate summary page. Some have focused on a somewhat detailed table or “profile” summarizing some of the key information in Items 1, 5, 6, 7, 11 and 17. Others have focused on highlighting perceived negative factors in the offering, such as: (a) weakness of the franchisor’s financial position; (b) short history; (c) small number of franchisees; (d) kickbacks from vendors; (e) minimum royalty requirements; (f) personal guaranty requirements; (g) failure to provide financial performance information; and the list could go on.
Franchisor advocates tend to prefer the “profile” or “summary” approach. Franchisee advocates tend to favor the “negative factors” approach—sometimes referring to it as enhanced “risk factors”. State franchise examiners tend to dislike any such summary out of concern it could encourage franchisees to rely just on the cover sheet and not drill down to the important information contained throughout the FDD and a concern that too many “risk factors” dilute the value of risk factors.

This paper does not propose a solution, recognizing that all positions have some merit. However, the lack of consensus does not mean that there is no value in leaving such a proposal on the table as the franchising community begins the conversation about the form that franchise disclosure should and will take over the next 40 years.

The obstacles to any of the format changes discussed here would be predictable and significant. They include: the need to re-educate lawyers and franchisors and federal and state regulators to a new paradigm; the need to introduce franchisees and their advisors as to where to find information; and the need for franchisor lawyers to change their templates. Change is difficult. Contemplating change can be unsettling. The franchise community might collectively decide, after extended discussion, to maintain the status quo. However, in the face of anecdotal evidence that the current franchise disclosure paradigm is ineffective in many cases, the community owes it to its constituencies to review whether we cannot do better than the current status quo in accomplishing the ultimate goal of franchise disclosure—providing prospective franchisees with the essential information they need to make informed investment decisions.

V. ENFORCEMENT

A. FTC

The FTC has made no secret of the fact that in the wake of the great recession it has been focusing its enforcement resources on so-called “bottom dollar frauds” that victimize jobless consumers who can least afford to lose their savings. Thus, after the divorce of the business opportunity provisions from the Amended Rule in 2007, the Commission has targeted business opportunity frauds requiring a relatively modest initial investment. Moreover, once the amended Business Opportunity Rule took effect on March 1, 2012, the FTC and its federal and state partners launched a major enforcement sweep, “Operation Lost Opportunity,” that included 70 actions against business opportunity sellers. They included six FTC cases against sellers that failed to comply with the rule after the agency had notified them about its expanded coverage and new requirements.

102 16 C.F.R. § 437.
Although the FTC has continued to provide compliance guidance by issuing new FAQs since the Amended Rule took effect, there have been no reported enforcement actions against franchisors. There is no way to know whether the FTC has launched investigations of Amended Rule violations because all FTC investigations remain non-public until the filing of a complaint in federal court. Moreover, franchisors that receive competent legal advice can often avoid litigation by showing that any violations prompting an FTC investigation have not resulted in economic injury, a *sine qua non* for enforcement action by the agency.

As a relatively small federal agency with broad authority to prevent unfair or deceptive acts and practices, the FTC necessarily relies on voluntary compliance with the rules it issues to provide bright-line standards for businesses that wish to avoid enforcement action. At the same time, the agency undoubtedly recognizes that enforcement is necessary both to create an economic incentive for businesses to comply and to arm counsel with persuasive examples of the costs of non-compliance. Based on the more than 50 FTC enforcement actions against franchisors under the Original Rule, it is reasonable to predict that the agency will pursue cases targeting financial performance representations that lack a reasonable basis, an allegation common to most of its past franchise enforcement actions. The only question is when.

Recognizing that many, if not most, franchisors do make an effort to substantially comply with the Franchise Rule, we raise the question of whether the absence of enforcement actions for nearly a decade is a good thing for the industry. Every industry has bad actors. When those bad actors get away with non-compliance, it can cause others to follow—in order to compete. If others are getting away with non-compliance and being able to more easily sell franchises, then why should we spend the resources to comply?

No one wants to become the target of an FTC enforcement action. However, one could argue that the absence of enforcement by the FTC is one root cause of the current wave of efforts by franchisees to secure state legislation to protect their rights—with private enforcement provisions. If the effect of competition and the market-place is to incent franchisors toward the lowest common denominator of compliance with the Amended Rule, then the only remedies for franchisees, absent FTC enforcement, are either stronger state laws, more lawsuits, or personal bankruptcy. Perhaps it is time for the FTC to use its power of persuasion to raise the standards of compliance and help to root out the truly bad actors who, if unchecked, could continue to drag franchising down.

B. States

There has been some administrative enforcement activity at the state level. There is no consistency among the states in making information regarding enforcement proceedings public and accessible. In Hawaii, all such records are confidential and unavailable. In a few states, the information is available online and is well indexed and accessible. In some states, the information is co-mingled with other enforcement actions and not readily searchable or otherwise accessible. Virginia simply publishes a list of the date, defendant name, case

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106 E.g., Rhode Island ([www.dbr.state.ri.us/decisions/decisions_securities.php](http://www.dbr.state.ri.us/decisions/decisions_securities.php)), Minnesota ([www.cards.commerce.state.mn.us/cards/](http://www.cards.commerce.state.mn.us/cards/)), Maryland ([http://www.oag.state.md.us/Securities/Actions/index.htm](http://www.oag.state.md.us/Securities/Actions/index.htm)) (requires some searching skills).

number and type of order for all “Enforcement Orders and Judgments” issued by the Division of Securities & Retail Franchising for the prior year and each year before that back to 2008.\textsuperscript{108}

Based upon the limited information publicly available, state enforcement rarely involves more than either a consent order or a default cease and desist order—sometimes involving a “fine” of from a few hundred to a few thousand dollars. It appears that the vast majority of actions involve the “low-hanging fruit” of cases involving failure to register. Although the paucity of public information makes clear conclusions impossible, there is little evidence of any state taking action to enforce substantive issues of fraud or non-compliance with substantive disclosure obligations, including deceptive Item 19 disclosures.

The few states that conduct substantive reviews of franchise offerings\textsuperscript{109} probably have some enforcement effect that results in better disclosures to franchisees, although, anecdotally, much of the focus of the state examiners is on technical compliance with the disclosure rules rather than substantive enforcement. It is also likely that some of the reviews, comments and requirements of the registration states have a salutary spill-over effect into some of the non-registration states.

Recognizing that the states, like the Federal Trade Commission, work under severe budgetary and political constraints, perhaps it is time for a radical shift in terms of how they allocate those resources. Perhaps transferring some resources from the registration and technical compliance aspects of their jobs and pursuing a few carefully selected substantive enforcement cases where there has been active fraud, misrepresentation or deceit would provide a better “bang for the buck”. Many franchise agreements are carefully written to make dispute resolution practically impossible for franchisees to pursue regardless of how egregious the fraud. They do this through mediation and arbitration provisions, waivers of the franchisee’s state laws, waivers of class actions or group actions, limitations on when an action can be commenced, and limitations on remedies. In many of the “low-investment” franchises, the amount lost by any franchisee, although often the franchisee’s entire life savings, is insufficient to justify the cost of pursuing a claim. In such cases, as in the small-damages securities fraud cases, it serves no practical purpose to tell the franchisee to “hire a lawyer”.

Such low-end franchise fraud cases present the states with unique opportunities to provide a valuable service for franchisees, to enforce the laws, and to send a clear message to franchisors that the states are serious about enforcing more than the placement of commas or the bolding of an Item heading. In many cases, the enforcement actions would be self-supporting (not requiring a net taxpayer subsidy) because of the states’ ability to collect attorneys’ fees, costs and penalties. Because the states are not parties to the contracts, but would be proceeding in their law enforcement capacities, they would not be subject to the onerous dispute resolution procedures, waivers and other devices designed to make dispute resolution by franchisees as near to impossible as it can be.

Obviously no state could or should take on every case for every unhappy franchisee. However, it would be well within the law enforcement authority of most states to pursue a few carefully selected claims as a matter of law enforcement and as a tool to educate franchisors as to what is required to offer and sell franchises and of the consequences for flaunting those requirements. Even if a case did not (or could not) result in a monetary recovery for the specific

\textsuperscript{108} See \url{http://www.scc.virginia.gov/srf/OrdersJudgments.pdf}.

\textsuperscript{109} California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia and Washington are the only states that purport to do a substantive review. See CCH Business Franchise Guide ¶ 2012 (2013).
franchisee(s) on behalf of whom the state brought the enforcement action, it would have a substantial likelihood of modifying that franchisor’s behavior and the behavior of others who followed the proceeding.

An even simpler step the states could take to enhance law enforcement would be to make the results of their enforcement actions (at least the orders) public record and easily accessible. It is of little use if an individual trying to learn from the mistakes of others has to sort through hundreds of securities orders or mortgage company orders to find three or four relevant franchise orders. If the only way in to the data is to know the name of the franchisor involved in the case, it is not useful. Those files need to be readily accessible to the public. A uniform and centralized system of captioning and filing among the states would be a huge help. Without such information being readily available, a prospective franchisee has no meaningful ability to see if the franchisor they are considering investing with has been subject to an order. Anecdotally, those orders rarely get disclosed in the Franchise Disclosure Document used outside the state issuing the order. Likewise, franchise lawyers have little ability to use those public files to persuade their franchisor clients of the wisdom of full compliance.

C. Private Right of Action

Given the limits of enforcement resources available to the Federal Trade Commission and the states, the only truly viable law enforcement mechanism is a private right of action. One of the reasons that the FTC Franchise Rule has had only modest effectiveness in preventing fraud in the offer and sales of franchises is that every attorney has to honestly answer questions from their franchisor clients by advising that the risk of an FTC enforcement action is nearly non-existent. In most states, that removes from consideration the only possible opponent with the resources to impose any consequences.

Similarly, on the state level, inquiring franchisors are properly advised that, so long as they file for registration in a few states and have a Franchise Disclosure Document that covers the 23 items in sufficient detail to get past the handful of examiners who will carefully read it, they have virtually no risk of any enforcement action by the states. As discussed above, virtually all state enforcement actions are for purely “technical” violations, usually involving failure to register. Once registered, the franchisor’s risk is minimal. Even if franchisees complain to their state, the risk of the state looking beyond “technical” compliance is small.

Recognizing the political and practical hurdles that would be involved, one of the best things Congress could do for franchisees is to amend the FTC Act to provide for a private right of action to enforce the Franchise Rule. Because that may not happen in this millennium, the second best thing government could do is for more states to adopt anti-fraud laws modeled after the securities laws and to provide for a private right of action to enforce those laws. The states could make it simple by adopting the Amended Rule verbatim by regulation and then permitting for private enforcement of their regulations.

It has been long accepted that the common law provides inadequate remedies for investment fraud and deceit. In most states, franchisees are left with trying to prove the nine elements of common law fraud. Because of the heightened evidentiary requirements for proof of common law fraud, such cases rarely succeed. The widespread use of franchise sales questionnaires requiring franchisees, as a condition to entering into the then-coveted franchise agreement to sign a document that they did not rely upon any fraudulent statements, even while representing that no fraudulent statements were made, effectively acts as a waiver, in advance, of any fraud that was committed.
The solution, adopted by a few states, is statutory anti-fraud provisions that cannot be waived coupled with a private right of action. If such provisions existed in more states, it would be a big step forward in cleaning up the abusive side of franchising. Franchise sellers would then have to behave differently to avoid litigation and the risk of liability for their fraud and deceit.

D. Why Enforcement?

Education. Deterrence. Punishment. Regardless of the remedial law being enforced, the reasons for enforcement boil down to those three things—and they tend to operate hand in glove. The first goal is to educate the people who are subject to the regulation about what the requirements are. The second goal is to discourage bad behavior while encouraging good compliant behavior. The third goal is to impose consequences on people who have made the decision to disregard or flaunt the law. Vigorous and persistent law enforcement is good for franchisors because it helps to raise the standard that all franchisors will then meet while leveling the playing field and weeding out the bad actors. It is good for franchisees because it assures them that their investment will not be wasted because they met a bad actor. It helps both franchisees and franchisors by creating a level playing field in a robust and free marketplace.

VI. CONCLUSION

The Amended Rule clearly has taken center stage with respect to the franchise disclosure process, and the states have largely conceded the FTC’s leadership role. But, while the FDD format promulgated by the FTC is now the standard, it has only modestly affected the patchwork quilt of state regulatory review. Accordingly, notwithstanding the advent of the FDD in 2007, the states with franchise disclosure laws continue to function much as they always did. Inconsistent review standards, registration delays and other state idiosyncrasies continue to be the norm. Perhaps at least one beneficial change should be acknowledged: the increased number and scope of exemptions has made life earlier for franchisors, albeit only for the larger and more experienced companies.

What can be done to improve the disclosure process and promote uniformity? Both franchisor and franchisee advocates likely would opt for more streamlined disclosure, whether through a revamped FDD or some other way to more concisely provide critical information to prospects. Franchisors would like to see less variation from one franchise registration state to the next or, at the very least, a more extensive menu of exemption alternatives. Franchisees would prefer a private right of action for violations of the Amended Rule; after all, 36 states do not offer any direct statutory basis to redress disclosure shortfalls. All parties would like to see a heightened degree of compliance from start-up and development stage franchisors, who often are advised by professionals and consultants who are unfamiliar with franchise laws.

Some other suggestions are provided elsewhere in this paper. But it is becoming clearer to the authors that the promise of the Amended Rule has not been fulfilled. And to effect improvements, the entire disclosure regime and the documents used in that process should be the subject of analysis and review by all elements of the industry and the agencies overseeing them.
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