FRANCHISE EXAMINER FORUM:
ADVANCED DISCLOSURE ISSUES

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I. INTRODUCTION

The Federal Trade Commission's franchise rule ("FTC Rule" or "Rule")\(^1\) establishes the disclosure requirements for sales of franchises in the United States (including its territories).\(^2\) However, it is not sufficient merely to read the text of the Rule when drafting a franchise disclosure document ("FDD"). Numerous federal sources interpret the requirements of the Rule, including (among others) the Statement of Basis and Purpose,\(^3\) the Compliance Guide,\(^4\) and the Frequently Asked Questions ("FAQs")\(^5\) addressed by the FTC Staff.

Other essential resources include the 2008 Franchise Registration and Disclosure Guidelines ("NASAA's 2008 Franchise Guidelines") adopted by the North American Securities Administrators Association ("NASAA")\(^6\) and the related NASAA Commentary.\(^7\) When it adopted the 2007 amendments to the FTC Rule, the Commission withdrew permission to use the state-based UFOC Guidelines\(^8\) since they “no longer afford prospective franchisees equal or greater protection” as the FTC Rule.\(^9\) In doing so, the Commission noted that its action "would not preclude consideration of any new or revised UFOC Guidelines promulgated by the states in the future."\(^10\) While NASAA's 2008 Franchise Guidelines and the subsequent NASAA Commentary are not new UFOC Guidelines, “as a practical matter, state franchise examiners, not the FTC Staff, regularly review Disclosure Documents, interpret the disclosure requirements of the FTC

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\(^1\) 16 C.F.R. Part 436 (2007), Disclosure Requirements And Prohibitions Concerning Franchising. All references to the Rule are to the 2007 Rule, except as otherwise expressly noted.


\(^5\) The FTC’s Frequently Asked Questions (FAQs), addressed by the FTC Staff in connection with the Rule and found at http://www.ftc.gov/bcp/finance/amended-rule-faqs.shtml.


\(^7\) The Commentary was issued by NASAA on April 27, 2009 and is found at http://www.nasaa.org/content/files/NFRA-Commentary_final.pdf. An excellent discussion of these and other resources can be found at Warren Lee Lewis, *Overview of the FTC Rule and Related Authorities*, The FTC Franchise Rule (Second Edition, 2012) Ed. Susan Grueneberg and Ann Hurwitz.

\(^8\) The Guidelines for Preparation of the Uniform Franchise Offering Circular and Related Documents adopted by NASAA on April 25, 1993 and approved by the Commission as an alternative to the original FTC Rule disclosure format on December 30, 1993.


\(^10\) *Id.*
Rule, and either approve or disapprove registrations of Disclosure Documents based on those interpretations."11 This makes NASAA’s pronouncements very relevant for practitioners.

This paper reviews selected disclosure issues under the FTC Rule, as explained and interpreted by these resources.

II. SELECTED DISCLOSURE ISSUES

A. FDD Disclaimers

1. Federal and State Guidance

The FTC Rule mandates the inclusion of certain disclaimers in the FDD including the following:

**Cover Page:**

"Note, however, that no governmental agency has verified the information contained in this document."12

"The terms of your contract will govern your franchise relationship. Don’t rely on the disclosure document alone to understand your contract. . . ."13

**Item 11**

"Except as listed below, [the franchisor] is not required to provide you with any assistance."14

**Item 12**

"If the franchisor does not grant an exclusive territory, state: 'You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control."15

**Item 13**

"If the trademark is not registered on the Principal Register of the United States Patent and Trademark Office, state: 'We do not have a federal registration

\[supra, n. 8.\]

12 16 C.F.R. §436.3(e)(2).

13 16 C.F.R. §436.3(e)(3).

14 16 C.F.R. §436.5 (k).

15 16 C.F.R. §436.5(l)(5)(i). Also, see FAQ #37.
for our principal trademark. Therefore, our trademark does not have many of the legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses.\(^{16}\)

Item 19

"If a franchisor does not provide any financial performance representation in Item 19, also state:

We do not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name, address, and telephone number] the Federal Trade Commission, and the appropriate state regulatory agencies.\(^{17}\)

NASAA's 2008 Franchise Guidelines require a state cover page disclaimer regarding the use of franchise brokers and referral sources: "We use the services of one more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A franchise broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should be sure to do your own investigation of the franchise."\(^{18}\)

Apart from the mandated disclaimers, the Rule contains an affirmative prohibition against disclaiming representations made in the FDD, its exhibits and amendments, making it an unfair or deceptive act or practice under Section 5 of the Federal Trade Commission Act for any franchise seller covered by the Rule to "[d]isclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments. . . ."\(^{19}\)

Section 436.9(h) was targeted at a specific practice identified during the rulemaking process: the use of franchise agreement integration clauses as a way of disclaiming responsibility for information in the FDD:

"By signing a franchise agreement containing such a clause, franchisees effectively waive any rights they may have to rely on information contained in the

\(^{16}\) 16 C.F.R. §436.5(m)(4).

\(^{17}\) 16 C.F.R. §436.5(s)(2).

\(^{18}\) 2008 NASAA Guidelines, supra, n.6.

\(^{19}\) 16 C.F.R. §436.9(h).
disclosure document. The use of such clauses, therefore, may lead to deception by enabling franchisors to make incomplete, inaccurate, or even false statements in their disclosure documents, while prospects effectively waive reliance on any such statements by signing the franchise agreement."\textsuperscript{20}

The Compliance Guide suggests a sample integration provision that recognizes the prohibition and satisfies the Rule:

"This Agreement and all exhibits to this Agreement constitute the entire agreement between the parties and supersede any and all prior negotiations, understandings, representations and agreements. \textit{Nothing in this or in any related agreement, however, is intended to disclaim the representations we made in the franchise disclosure document that we furnished to you.}"\textsuperscript{21} (Emphasis added.)

The Commission specifically found that by prohibiting the integration clause practice, "the disclaimer prohibition preserves the integrity of the material information disclosed in a franchisor's disclosure document . . . . "\textsuperscript{22}

But although a disclaimer may serve as the "denial . . . of responsibility," "[a] disclaimer is [also] a defensive measure, used generally with the purpose of protection from unwanted claims or liability. . . . a disclaimer clause in a contract might set forth certain promises and deny all other promises or responsibilities.\textsuperscript{23} Are there ways that a franchisor may legitimately limit its disclosures and remain in compliance with the Rule's prohibition against disclaimers and waivers of representations made in the disclosure document or in its exhibits or amendments?

The Commission has acknowledged that there may be instances where integration clauses, waivers, and disclaimers may serve a valid purpose. "For example, a franchisor reasonably may seek to disclaim responsibility for unauthorized claims made by former or existing franchisees, or unattributed statements found in the trade press."\textsuperscript{24} But these types of disclaimers and waivers would not necessarily appear in an FDD.\textsuperscript{25}

With regard to the FDD, the Commission has recognized that franchisors have ways other than integration clauses to narrow their disclosures. Using an Item 19 example, the Commission noted that "[n]othing in section 436.9(h) would prevent a franchisor from having a

\begin{footnotesize}
\item 20 72 Fed. Reg. 15533.
\item 21 Compliance Guide, p. 143.
\item 22 72 Fed. Reg. 15535.
\item 23 http://legaldictionary.thefreedictionary.com/disclaimer.
\item 24 72 Fed. Reg. 15534.
\item 25 The use of disclaimers outside the FDD is beyond the scope of this paper. However, see Carmen D. Caruso, Elizabeth M. Weldon and Jonathan C. Solish, \textit{Disclaimers: A Powerful Tool of Franchisors or Fickle Follies in the Wake of the Amended FTC Franchise Rule?} ABA 36th Annual Forum on Franchising, W17 (2013).
\end{footnotesize}
prospective franchisee sign a clear and conspicuous acknowledgment that . . . [a] performance representation [based on a particular state] does not apply to [dissimilar] states."\textsuperscript{26}

But, there are limits. The FTC Staff has opined that requiring a prospective franchisee to provide a list of statements from the FDD that it deems to be material would be counter to §436.9(h). According to the Staff,

"... section 436.9(h) reflects a Commission finding that each disclosure required by the Rule is material to a prospective franchisee's investment decision. . . . Forcing a prospective franchisee to designate certain select statements as 'material' would invite the conclusion that statements not selected are not material, and a court reasonably could construe a franchisee's failure to select one or more particular statements as the prospective franchisee's waiver of reliance on those particular statements."\textsuperscript{27}

Similarly, although a franchisor can ask the prospective franchisee for assistance in identifying all applicable franchise sellers for the Item 23 Receipt, it cannot shift its disclosure burden of identifying franchise sellers to prospective franchisees\textsuperscript{28} nor can it require prospective franchisees to sign a general release in a franchise agreement or other document as a condition of obtaining the franchise unless the release "expressly excludes claims arising from representations in the FDD, its exhibits or amendments."\textsuperscript{29}

The FTC Rule also prohibits including in the FDD "any materials or information other than those required or permitted by [the Rule] or by state law not preempted by [the Rule]."\textsuperscript{30} The policy reflected in §436.6(d) is a carry-over from the original FTC Rule ("Original Rule").\textsuperscript{31} During the process of amending the Rule, the Commission found the prohibition "necessary to ensure that franchisors do not include information that is non-material, confusing or distracting from the core disclosures."\textsuperscript{32}

Concerns were expressed during the rulemaking process that this limitation could prove to be an "unfair trap" for franchisors:

"... a franchisor or subfranchisor sometimes needs to include information in a disclosure document that it believes is material or possibly material (even though

\textsuperscript{26} 72 Fed. Reg. 15535.

\textsuperscript{27} FAQ #21.

\textsuperscript{28} FAQ #23.

\textsuperscript{29} FAQ #34.

\textsuperscript{30} 16 C.F.R. §436.6(d).

\textsuperscript{31} The original FTC Franchise Rule, "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," 16 C.F.R. Part 436 was promulgated December 21, 1978 and became effective October 21, 1979.

\textsuperscript{32} 72 Fed. Reg. 15516.
the information is not required or permitted under federal or state law) or that it believes will help a prospect to better understand required information or its significance. Providing supplementary or explanatory information of this type should not be a rule violation, unless the information is excessive, misleading, or intentionally diversionary." 33

Despite these concerns, the Commission declined to revise its long-standing limitation on a franchisor including disclosures in an FDD not specifically required or permitted under the Rule, stating that the limitation was "necessary to ensure that a franchisor does not bulk-up a disclosure document with unnecessary information or features that will discourage a prospective franchisee from reading the document or distract a prospective franchisee's attention from negative disclosures". 34

According to the Commission, a franchisor is not exposed to a Rule violation "for failing to include material information not specifically required or permitted by the Rule or state law." 35 However, compliance with the Rule will not shield franchisors from potential liability if they engage in other unfair or deceptive acts or practices. 36 The final Rule contains an express acknowledgment that "franchisors may have additional obligations to impart material information to prospective franchisees outside of the disclosure document under Section 5 of the Federal Trade Commission Act." 37 However, this does not alter that part of the Rule limiting disclosures in the FDD only to those that are authorized or permitted.

Notwithstanding §436.6(d), the FTC Staff has authorized the addition of an Item 19 disclaimer not contained in the Rule. The disclaimer is intended for use by a franchisor that makes an Item 19 financial performance representation but wants to include a statement that it does not make any financial performance representation other than the one included in Item 19 and has not authorized any employee to do so. 38 The authorized addition is based on

33 Id.
34 Id.
36 Id.
37 16 C.F.R. §436.10(a). The examples of additional material disclosures given by the Commission all relate to the original FTC Rule. See note 934 of the Statement of Basis and Purpose, 72 Fed. Reg. 15536. In note 934, the Commission observes that the original FTC Rule did not require disclosure of federal or state licensing provisions. Yet, actions alleging violations of Section 5 of the FTC Act were brought against franchisors for allegedly "misrepresenting that purchasers of their emergency alert system franchises would not have to register with state or local authorities;" "failing to disclose state insurance licensing requirements;" and "misrepresenting the availability of medical insurance."
38 FAQ #27. The disclaimer must be exactly as presented in FAQ #27, with no modification and included at the very end of Item 19. But, see the discussion regarding the NASAA position at Section II.B.(1)(b), infra.
longstanding industry practice and the Staff's view that such practice is consistent with the public interest.\textsuperscript{39}

Apart from these additional authorized disclaimers and clear and conspicuous acknowledgments that may be used to narrow disclosures, franchisors may add brief footnotes to ensure their disclosures are accurate, complete and not misleading. In adopting §436.6(d), the Commission noted that the prohibition should be "read narrowly" as prohibiting only the addition of materials not required or permitted by the Rule. The Commission acknowledged the value of including additional information if necessary to ensure the accuracy of the required disclosures. Therefore, there is no prohibition against the addition of "brief footnotes or other clarifications to ensure that the disclosure is complete and not misleading."\textsuperscript{40}

2. Practice Tips

- Where necessary to ensure the accuracy of the required disclosures, add brief footnotes or other clarifications to ensure that the disclosure is complete and not misleading.

- Where the circumstances warrant, narrow the disclosures made using a clear and conspicuous acknowledgment — but be careful that the acknowledgment does not act as a waiver by the franchisee of reliance on representations made in the FDD, its exhibits or amendments.

- If a particular disclaimer appears consistent with the public interest, consider whether to request authorization of the addition in discussions with state examiners; for example, the inclusion in Item 17 of disclosures relating to franchise agreement provisions containing jury and damages waivers and contractual statutes of limitation.

B. FPR Disclaimers

1. Federal Rule, NASAA and State Positions

   a. Preamble

Franchisors must elect whether to make a financial performance representation ("FPR") in Item 19. Election to omit an FPR triggers disclaimers of the right of the franchisor to provide this information through any other means or mechanism, as follows:

We do not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future

\textsuperscript{39} Id.

\textsuperscript{40} 72 Fed. Reg. 15516.
income, you should report it to the franchisor’s management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

Alternatively, if the franchisor elects to make an FPR, the FTC requires it to disclaim its right to provide any different information, using the following language:

… Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

Neither the language nor the placement of either preamble is negotiable. In either instance, the language must appear at the beginning of the Item 19 disclosure. The Commission’s goal in enacting these disclaimers was to eliminate the then-prevalent practice among franchise salespeople of telling prospective franchisees that the FTC Rule prohibited earnings claims, and to prevent franchisors from using unsubstantiated earnings claims. In 2007, when adopting the current Rule, the Commission quoted the American Franchisee Association as follows:

"[T]he great untruth that franchise salespeople have been allowed to perpetrate over the years is the following statement in one form or another - the federal government prohibits us from giving you information regarding the financial performance of [name of our] franchises."41

The required preamble language is designed to provide prospective franchisees with legally accurate information and encourages them to report non-compliant franchisors. Presumably, all franchisors which register an FDD through any state regulatory agency are in compliance with this required disclaimer section.

b. Admonition

The franchisor must also include, "[a] clear and conspicuous admonition that a new franchisee’s individual financial results may differ from the result stated in the financial performance representation." Although this admonition is not a disclaimer of responsibility for the FPR provided in the FDD or the accuracy of the information, its function is to provide some protection to franchisors from a franchisee whose sales are different from those contained in the FPR.42

The FTC Compliance Guide suggests a form of clear and conspicuous admonition that would satisfy this requirement.43 Subsequent to the publication of the FTC Compliance Guide,


42 In contrast to the denial of responsibility that a disclaimer implies, an admonition is a warning. http://legal-dictionary.thefreedictionary.com

43 For historical representations -
however, NASAA issued its own Commentary that includes a slightly different form of admonition that would satisfy Item 19. The NASAA-suggested admonition is similar to the admonition suggested in the FTC Compliance Guide, but the two versions are not identical. Like the FTC Compliance Guide, the NASAA Commentary notes that Item 19 does not require any specific language, yet the NASAA Commentary leaves little doubt that the NASAA-approved admonition is the language that state franchise examiners expect franchisors to use. Because the NASAA Commentary was issued after the FTC Compliance Guide and is the source of information relied upon by state franchise examiners, the NASAA form of admonition is the one that franchisors should use, especially in the franchise registration states.

Specifically, the NASAA Commentary states that franchisors should use one of the following admonitions:

For historical representations—

"Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."

For projections—

"These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."

NASAA's Commentary instructs that the admonition should be included in a separate paragraph. In addition, the NASAA Commentary cautions that, "[i]n either case, franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented." In practice, not all franchisors adhere to the specific language of either the NASAA Commentary admonition or the FTC Compliance Guide admonition. Those modifying the language often list additional bases on which franchisee results may differ, such as the length of time a franchise outlet has been established or the area in which it is located. When well drafted, the language of these alternate admonitions may not violate the FTC prohibition on disclaiming the FPR itself. However, in some circumstances the cumulative impression of an extremely long list of bases on which results may differ is that the franchisor is attempting to distance itself from its FPR, in violation of the FTC's guidelines.

"Some [outlets] have [sold] [earned] this amount. There is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well."

For projections -

"These figures are only estimates of what we think you may [sell] [earn]. There is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well."

44 Section 19.3 of the NASAA Commentary.

45 Id.
c. Substantiation

The FTC also requires a franchisor to include a statement that written substantiation of its FPR is available to the franchisee upon reasonable request. Although not strictly a disclaimer, this requirement prohibits a franchisor from refusing to disclose the data from which its FPR was constructed. The information that makes up this substantiation can vary widely, and there is no specific format prescribed for the disclosure. However, franchisors may not refuse to provide additional substantiating information or set up unreasonable barriers to access. In many states, the failure to provide this substantiating information constitutes an actionable misrepresentation under the state's franchise law.46

2. Practice Tips

- If making a financial performance representation, consider whether one of the NASAA-approved admonitions will cover the requirement for the admonition.

- If expanding or modifying a suggested admonition, limit the changes to only the statements necessary to supply required information to a prospective franchisee, and avoid including so many speculative bases on which a franchisee's performance might differ that the FPR itself is disclaimed.

- Do not put disclaimer or admonition language in bold, capital letters, a larger font size, or repeat it multiple times. Emphasis is only permitted when authorized by statute or guidelines.

- In addition to strict compliance with FPR requirements as stated in Item 19, if no FPR is made, or if a very limited FPR is made (e.g., gross revenue only), avoid providing information that may allow a franchisee to construct a revenue representation you did not intend. This includes providing cost information as a percentage of revenue, or approving a pro forma with cost or revenue information supplied by the prospective franchisee after discussion with franchisees in the system.

- FPRs may be made in a variety of ways, some inadvertent, including statements made to the general media, if they are made in a forum or format that is likely to attract franchise interest. While there is a limited exception that permits a company to release some financial information in the course of a speech or press release, if the franchisor later points franchisees to that content, it will constitute an FPR. Before making a public statement about finances, practitioners should carefully review FTC Staff's guidance in the Compliance Guide at pages 131-134.

C. FPRs - Use of Franchisor-only Data

FTC Staff pronouncements address the circumstances under which a franchisor with no adequate performance data of its own on which to base an FPR may prepare an FPR using

46 In South Dakota, this is explicitly codified. S.D. Codified Laws § 37-5B-26(4).
financial information from an affiliate operating a substantially similar business. The FTC Rule and Compliance Guide also permit financial performance representations based on franchisor-only data. However, questions have been raised as to whether FPRs based on franchisor-only data are permitted in all circumstances, particularly when the franchisor has franchised units that have been operating for some time.

1. Federal and State Guidance

Item 19 of the FTC Rule permits, but does not require, franchisors to make financial performance representations. The Rule also permits franchisors to base their financial performance representations on "... a subset of outlets that share a particular set of characteristics (for example, geographic location, type of location (such as free standing vs. shopping center), degree of competition, length of time the outlets have operated, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated." However, if a franchisor makes a financial performance representation, the Rule requires the franchisor to "... have a reasonable basis and written substantiation for the representation at the time the representation is made."

The FTC's Compliance Guide states expressly that: "The group from which data is gathered [for a historic financial performance representation] need not be comprised of franchised outlets. It may be a group consisting of company-owned outlets, or in certain limited circumstances, a group of reasonably similar outlets of an affiliate with operations reasonably similar to those of the franchisor making the offering in question ..." (Emphasis added) This statement is qualified by two provisos: first, that any financial representation "must be reasonable and supported by the data collected from that group" and second, that the "disclosure must make clear whether the claim is based on the experience of company-owned outlets, of outlets of an affiliate with reasonably similar operations, or of franchised outlets in the same system as those being offered for sale."

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47 FAQ #8.

48 16 C.F.R. §436.5(s)(3)(ii)(A) and Compliance Guide, at pp. 87-88.

49 See the references to state comment letters in the subsequent discussion and Hanley v. Doctors Express Franchising, LLC, 2013 W 690521 (D. Md. 2013) (Franchisee alleges that franchisor knew that basing its FPR on the experience and data of its local affiliate was materially misleading to prospective franchisees because the affiliate’s experience was not representative of the experience of new franchisees.)

50 16 C.F.R. §436.5(s)(1).


53 Compliance Guide, pp. 87-88.

54 Id.
In discussing its decision to allow the use of subgroup data in financial performance representations, the Commission noted the parameters surrounding the use of that data:

"Specifically, the financial information furnished to prospective franchisees must have a reasonable basis and the franchisor must disclose: (1) the nature of the universe of outlets measured; (2) the total number of outlets in the universe measured; (3) the number of outlets from the universe that were actually measured; and any characteristics of the measured outlets that may differ materially from the outlet offered to the prospective franchisee (e.g., location, years in operation, franchisor-owned or franchisee owned and likely competition)."\(^{55}\)

The Commission believed that allowing the use of subgroup data, along with other changes to Item 19, would "remove obstacles that discourage franchisors from making financial performance data available to prospective franchisees,"\(^{56}\) thereby increasing the availability of admittedly material information without mandating that all franchisors provide a financial performance representation. The Commission also noted that:

"... Item 19's substantiation requirements ensure that franchisors disclose how they derived the performance results of subgroups, so that prospective franchisees can assess for themselves the sample size, the number of franchisees responding, and the weight of the results. In addition, these provisions require franchisors to disclose the material differences between the subgroup-units tested and the units being offered for sale, so that prospects can avoid drawing unreasonable inferences from the representations."\(^{57}\)

Franchisors making Item 19 representations based solely on franchisor data have received comment letters from some registration states asking that they "state the total number of franchisees that existed in the relevant time period and also, state why their results were not included in this item"\(^{58}\) or that they "disclose the reasonable basis for the inclusion of only company-owned outlets."\(^{59}\) In the systems that received these comment letters, the number of franchised outlets were greater than the number of company-owned outlets.

As noted above, in addition to the Rule's Item 19 disclosure requirements under §436.5(s), the Rule also makes it a violation of Section 5 of the Federal Trade Commission Act for any covered franchise seller to "[d]isseminate any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the representation at the time the representation is made . . . ."\(^{60}\)

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\(^{56}\) Id.

\(^{57}\) Id.

\(^{58}\) 2013 California comment letter sent to a client of one of the authors.

\(^{59}\) 2009 Maryland comment letter sent to a client of one of the authors.

\(^{60}\) 16 C.F.R. §436.9(c).
Explaining the "reasonable basis" requirement, the Compliance Guide states:

"Written factual information in the seller's possession must reasonably support the representation, as it is likely to be understood by a reasonable prospective franchisee. This factual information must be the sort of information upon which a prudent businessperson would rely in making an investment decision. Obviously, the quality and quantity of information constituting a reasonable basis may vary from case to case. The type of information needed to support and substantiate a financial performance representation will also vary, depending on whether the representation is a projection or a historic report of actual performance."61

In addressing whether Item 19 of the Rule prohibits the use of performance claims based on affiliate data, the FTC Staff opined that, "... in limited circumstances, a franchisor may base a financial performance claim upon the results of operations of the substantially similar business of an affiliate. 62 However, the Staff stated: "All financial performance representations must have a 'reasonable basis.' When a franchisor has adequate performance data of its own upon which to base a performance representation, basing a performance representation on affiliate information likely would not be 'reasonable.'"63

The FTC Staff opinion concerning the use of affiliate data in lieu of franchisor data when the franchisor has adequate performance data of its own does not address the situation where a franchisor bases a representation on its own data rather than the data of its franchisees. A franchisor may not have access to or sufficient reason to trust franchisee data. Among the reasons the Commission gave for declining to mandate financial performance disclosures were the fact that:

"... not all franchisors have the contractual right to collect extensive financial information with which to prepare a reasonable performance disclosure; ... financial performance data collected from existing franchisees is not necessarily complete and accurate; ... mandating financial performance disclosures would have a negative impact upon the franchisor-franchisee relationship, subjecting franchisees to more extensive accounting oversight and audits. ... At the same time, it potentially could expose existing franchisees, upon whose data the franchisor would rely, ... to potential liability for indemnification should a franchisor, relying on the franchisees' performance data, be found to have violated the Rule by failing to furnish accurate financial performance data."64

Thus, the Commission recognized that even in systems with large numbers of franchisees, there are reasons not to require financial performance disclosures based on franchisee data.

62 FAQ #8.
63 Id.
64 72 Fed. Reg. 15498.
That said, "if a franchisor chooses to make [financial performance disclosures], the disclosures, of course, must be reasonable, non-misleading, and accurate." 65 If not, the franchisor subjects itself to potential liability. A company-owned outlet and a franchisee owned outlet may have materially different financial experiences. A franchisee outlet usually has costs and expenses that a company-owned outlet will not have, including royalties, advertising fees and others. There are also economies of scale that are more likely to be present in company-owned outlets. In addition, there may be other reasons why a company-owned outlet's experience will not be representative of the financial performance a franchisee may expect66 and that a franchisor may not be able to overcome by disclosing the characteristics of the company-owned outlets that differ materially from the characteristics of the franchised outlets being offered. It remains to be seen how these issues will be resolved by the courts and regulatory authorities.

2. **Practice Tips**

As there is so little guidance on these issues, it is difficult to formulate useful practice tips. However, at a minimum:

- When evaluating data for the preparation of an Item 19 financial performance representation, consider all relevant franchisor and franchisee data.

- If a franchisor has operational franchisees, and the franchisor makes a "gross sales" FPR, include the data from those franchisee outlets that have a sufficient operating history with the data from any company-owned outlets. When doing so, disclose the data from the company-owned outlets and franchisee outlets separately.

- Questions remain how (and whether) a franchisor without operational franchisees may make a "gross sales" FPR or an FPR disclosing sales, costs, and gross or net profits based solely on company-owned outlet data. Questions also remain how (and whether) a franchisor with operational franchisees may make an FPR disclosing sales, costs and gross or net profits based solely on company-owned outlet data. At a minimum, any franchisor which chooses to make such an FPR should include in the FPR detailed disclosures fully explaining any characteristics of the company-owned outlets that may differ materially from franchisee outlets in order to account for potential differences between company-owned outlets and franchisee outlets. Franchisors should not simply include a notation stating generally that there may be differences in the costs that a franchisee may incur; rather, the franchisor should provide detailed disclosures of royalties, advertising and other fees not paid by company-owned outlets, any other costs unique to franchisees or that may be higher for franchisees than for company-owned outlets due to efficiencies of scale that the company-owned outlets may enjoy, and any other material differences. While it is unclear whether the inclusion of such disclosures will be sufficient in all cases to establish reasonable basis,

65 *Id.*

66 See *Hanley v. Doctors Express Franchising, LLC*, *supra*, n. 50.
failure to include this information will raise questions as to whether there is a reasonable basis for the FPR.

D. Territorial Exclusivity

1. Federal Rule, NASAA and State Positions

   a. Defining the Exclusive Territory

   The legal definition of an "exclusive" territory remains a topic of great interest and some dispute among practitioners, salespeople, franchisors and franchisees. The Rule itself requires affirmative disclosure of whether the franchisor grants an exclusive territory. If it does not, the FDD must include a specific statement:

   "You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control."

   The Commission characterizes this language as a "warning about the consequences of purchasing a non-exclusive territory." Like the preamble language required in Item 19, this warning language is mandated in exactly these words if the franchisor does not grant an exclusive territory.

   The FTC has issued two FAQs to narrow down the exact definition of an exclusive territory. FAQ 25 provides the general definition:

   …Commission staff construe the term "exclusive territory" to mean a geographic area granted to a franchisee within which the franchisor promises not to establish either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks or service marks.

   If a franchise agreement omits either aspect of this two-fold commitment (neither company-owned nor franchised outlets within the territory), section 436.5(l)(5)(i) of the Rule requires the franchisor to insert [the disclaimer].

   That FAQ further clarifies that a franchisor's reservation of right to sell through alternate channels of trade, such as the internet, or through competitive brands, does not destroy exclusivity of the territory. In addition, because the Rule requires disclosure of whether the franchisor reserves these rights whether the granted territory is exclusive or non-exclusive, prospective franchisees will not be fooled into believing that their exclusive territory prohibits the franchisor from engaging in online sales under the brand or from establishing a different brand within the granted territory.

   However, the Commission's FAQ 37, issued October 16, 2012, recognizes a significant carve-out to this straightforward rule. If the franchisor reserves the right to place a company-owned or franchised outlet into a non-traditional location such as airports, arenas, hospitals, hotels, malls, military installations, national parks, schools, stadiums and theme parks within the granted territory, the franchisor loses the right to characterize the territory as "exclusive" and must use the disclaimer. The Commission reasons:
Because "non-traditional venues" entail an outlet physically located in a franchisee's territory, we can find no principled basis for interpreting "other channels of distribution" to include them. Accordingly, it is staff's view that a franchisor that reserves the right to sell through such "non-traditional venues" must make the disclosure that it does not provide an exclusive territory.

Many practitioners have observed that there are very few franchisors who grant a territory without a reservation of rights as to at least a few of the specified types of non-traditional location listed in FAQ 37. Consequently, the number of franchise systems claiming to grant exclusive territories is likely to plummet, while the territorial arrangements and the level of protection is variable.

Practitioners should avoid trying to use alternative terminology in order to suggest a special category of territory. The Commission views territories as either exclusive or non-exclusive, within its specific definitions. In crafting the Rule, the Commission explicitly considered and rejected a number of terms relating to territories. It found that the former Rule's terms "market area" and "defined area" implied a common law right to a territory that does not exist outside of a contractual grant, and it likewise rejected the adoption of the terms "protected territory" and "limited protected territory."

None of the states have laws that are at odds with these definitions. Hawaii's statute section 482E-6(2)(E) clarifies that an exclusive territory includes one in which either the franchisor or competing outlets solicit or sell to people residing with a franchisee's territory.

b. The Loss of Rights Loophole

FAQ 37 also addresses a loophole that was created by the statutory language of the Rule. The Rule's instructions for disclosure in Item 12 provide that if the franchisor grants an exclusive territory, it must disclose the bases on which continued territorial exclusivity depend. For example, if the franchisor reserves the right to modify the granted territory if the franchisee's sales fall below a required threshold or if the population within the franchisee's defined territory rises above a particular metric. If the franchisor does not grant an exclusive territory under the Commission's definition, however, a strict reading of the statute indicates that these disclosures are not appropriate.

In response to this, the Commission included a permissive statement in FAQ 37:

Staff recognizes that where a reservation of rights to make sales through "non-traditional venues" prevents a franchisor from offering an exclusive territory, Item 12 could be interpreted as prohibiting disclosure of the rights the franchisor is reserving. As a matter of enforcement policy, staff will not object to the inclusion of a disclosure in this instance of the specific rights the franchisor is reserving because it would not conflict with the mandatory disclosure that the franchisor does not grant an exclusive territory and the additional information would provide prospective franchisees with useful information about competition from "non-traditional venues."

Although listing the franchisor's reservation of rights where a non-exclusive territory is granted is clearly not mandated by the Commission, it is a best practice, particularly considering that prior to the release of this FAQ, many practitioners would have argued that such a territory constituted an exclusive territory, in which case the disclosure was mandated.
2. **Practice Tips**

- Use the warning/disclaimer in every instance in which the franchisor reserves any right to establish a company-owned or franchised outlet within any part of the geographic area granted to a franchisee, and do not characterize such a situation as an "exclusive territory."

- Include a definition of the territory being granted to the franchisee in the franchise agreement, even if the grant of protection is negligible, in order to avoid a good faith and fair dealing claim that because the contract was silent on territory, the franchisee may establish its own territorial limits as far as is reasonable.

- Fully disclose all of the bases on which a franchisor may alter a non-exclusive territory granted to a franchisee.

E. **Multi-Unit Disclosures**

1. **Federal, NASAA and State Positions**

   Multi-unit franchise arrangements encompass a broad range of terms and titles including master franchisees, subfranchisors, area developers, area representatives, and others. These titles are not always used uniformly and may be used differently between systems or practitioners. In general, master franchisees/subfranchisors control a territory and enter into franchise agreements within their territory with unit franchisees. They share the revenue received from those unit franchisees with the franchisor. Area developers are individual franchisees who contract directly with the franchisor to develop more than one franchise outlet, often in a contiguous area over a period of years. Area representatives function like subfranchisors in that they are charged with developing a territory, but once they identify acceptable unit franchisees, those franchisees enter into contracts directly with the franchisor. There is no contractual relationship between the area representative and the unit franchisee, although the area representative may retain some obligations in the territory, such as training, inspections, or some support services.

   a. **Subfranchisors Required to be Disclosed in FDD**

   The Rule requires that franchisors disclose subfranchisors, but the Commission's FAQs confirm that no disclosure of franchise brokers is necessary. FAQ 9 provides:

   Even if a person performs post-sale [services] on behalf of a franchisor, that person or entity is not a "subfranchisor" under the amended Rule unless that person is a party to the franchise agreement (or to another agreement involved in the franchise).\(^67\) This is true regardless of the name given to the person, be it "development agent," "area developer," or "regional developer."

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\(^67\) The franchise agreement in question is the agreement between the subfranchisor and the unit franchisee.
FAQ 20 adds context to this issue: "If... a franchise broker has no contractual post-sale obligations to the franchisee, it does not "participate in the franchise relationship" and disclosures about the broker are not required by the Rule."

NASAA defines a subfranchisor as "a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance." This definition alone might encompass an area representative who retains some post-sale obligations, but NASAA's Commentary guidance elsewhere clarifies that its definition of subfranchisors is focused on entities which enter into contracts with unit franchisees. In discussing the obligations under Item 20, NASAA states:

The charts in Item 20 refer to "outlets" which are defined as including "outlets of a type substantially similar to that offered to the prospective franchisee." Therefore, a subfranchisor's franchise disclosure document must include two sets of Item 20 charts: one listing all the individual outlets, whether franchised or subfranchised, in the entire system, and another listing only the individual subfranchised outlets for that particular subfranchisor. The subfranchisor's Item 20 charts should not include a listing of all subfranchisors in the system.

The states which have examined this issue have agreed that only those entities who are party to the franchise agreement must be included in the disclosures in the FDD.

The FTC Rule is silent as to which party in a subfranchise relationship bears the burden of preparing disclosures between the franchisor and subfranchisor. In practice, most franchisors prepare an FDD containing all of their own disclosures and collecting certain required disclosures from among the various subfranchisors in the system, including the subfranchise-specific disclosures for Items 3, 4 and 20. This is often called the "prototype" and it is frequently generated with highlighted areas for the subfranchisor's additions. The franchisor then circulates the prototype to each subfranchisor, who is directed to insert its own information into Items 1, 2, 7, 11 and any other sections as appropriate, adding exhibits and attachments as necessary.

Among the hazards of this system is that a subfranchisor may not pay enough attention to the portions of the document that are not marked by the franchisor for it to update. If there has been insufficient due diligence about costs or the way particular regions are actually operating, or if a subfranchisor has subtly changed the system without reporting that to the franchisor, both the franchisor and the subfranchisor run the risk of inaccurate disclosure in the resulting FDD.

b. Brokers and Agents

Although not required to be disclosed in the body of the FDD, each sales agent or franchise broker involved in a sale of a franchise must be disclosed in the receipts as a

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69 Section 20.4 of the NASAA Commentary.

70 However, there may be disclosures required regarding area developers in Item 1.
“franchise seller.” In FAQ 20, the FTC confirmed that a franchisor does not have an obligation to disclose that a franchise broker may offer a unit franchisee a rebate for purchasing a franchise. However, the franchisor remains obligated to ensure that the broker complies with general requirements of the Rule's sales guidelines.

2. Practice Tips

- Ignore the title assigned to various agents, developers, joint venturers, master franchisees or subfranchisors in the system when determining who must be included in FDD disclosures, and focus instead on the relationship with the unit franchisee. Any entity that enters into a franchise agreement with a unit franchisee should be treated as a subfranchisor for the purposes of disclosure.

- In a three tiered system that includes subfranchisors, ensure that accurate and meaningful communication and document review is taking place. Although indemnity agreements may offer some protection from a franchisee lawsuit alleging that a subfranchisor made inaccurate disclosures, the better practice is to remind subfranchisors to thoroughly review the document and to bring any changes or concerns to the franchisor's immediate attention.

- Double check the unit figures received from subfranchisors. Item 20 requires a franchise agreement for an outlet that is signed but never opened to be disclosed only in Table 5. However, some subfranchisors report signed franchise agreements as "outlets opened" in Table 4. Similarly, many subfranchisors inaccurately report outlets that close due to abandonment as outlets "reacquired by franchisor," falsely suggesting that these units remain in operation. Because a subfranchisor can double check its own region's figures but typically does not have access to the aggregate figures that are included in the tables in its prototype, it is crucial that the franchisor take responsibility in order to avoid an FDD that may grossly exaggerate the total number of operating franchise outlets nationwide.

F. Parent/Affiliate/Predecessor Disclosures

In addition to information about the franchisor, the FTC Rule requires disclosures related to the Franchisor's "parents," "affiliates" and any "predecessor". Each of these terms has specific meanings which may vary depending upon the particular disclosure item and which will affect the disclosures that are required.

1. Federal and State Guidance

Under the FTC Rule, the basic definition of "parent" is "an entity that controls another entity directly, or indirectly through one or more subsidiaries"\(^{71}\); the basic definition of "affiliate" is "an entity controlled by, controlling, or under common control with, another entity"\(^{72}\); and the

\(^{71}\) 16 C.F.R. §436.1(m).

\(^{72}\) 16 C.F.R. §436.1(b).
basic definition of "predecessor" is "a person from whom the franchisor acquired, directly or indirectly, the major portion of its assets."\(^{73}\)

The FTC Staff has noted that the Rule's definition of "parent" "focuses on 'control,' not mere ownership. Accordingly, a parent that merely owns, but does not control, a franchise system – for example, the parent does not shape the franchisor's policies or control franchise sales or operations – is not a 'parent' for purposes of any disclosure item."\(^{74}\)

With regard to the term "predecessor," NASAA has clarified that: "The definition of a predecessor does not mean mere equity owners of the franchisor. Implicit in the definition of 'predecessor' is the requirement that the predecessor contributed operating assets to the franchisor and itself operated or franchised a similar business. . . ."\(^{75}\)

Although these terms are used in various FDD Items, the scope of the required disclosures varies, depending on the particular Item.

- **Item 1 (The Franchisor, and any Parents, Predecessors, and Affiliates)** requires disclosure of the name and principal business address for (i) each parent, (ii) each affiliate that offers franchises in any line of business or provides products/services to franchisees,\(^{76}\) and (iii) any predecessors during the 10-year period immediately prior to the end of the franchisor's most recent fiscal year.\(^{77}\)

  - The prior business experience of each qualifying affiliate and predecessor must be disclosed, including the length of time each has conducted the business; the length of time they have offered franchises in the same line of business as the franchise offered (if applicable); and if the affiliate or predecessor has offered franchises in other lines of business, a description of the other franchise, the number of franchises sold, and how long they offered those franchises.\(^{78}\)

  - Parent company information is limited to the parent's name and principal business address but "parent" includes all parent companies, even intermediate parents, \textit{as long as the parent(s) "exercise control over the policies and direction of the franchise system."}\(^{79}\) (Emphasis added.) The policy reason for requiring such disclosure is "to ensure that a prospective franchisee understands who may influence the franchisor's operations."\(^{80}\) Franchisors are permitted to present

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\(^{73}\) 16 C.F.R. §436.1(p).

\(^{74}\) FAQ #16.

\(^{75}\) Section 1.3 of the NASAA Commentary.

\(^{76}\) 16 C.F.R. §436.5(a)(1).

\(^{77}\) 16 C.F.R. §436.5(a)(1).

\(^{78}\) 16 C.F.R. §436.5(a)(7).

\(^{79}\) FAQ #16.A.

information on numerous parent companies in chart form in Item 1, as long as the information is presented in a clear, understandable format that is not misleading.\textsuperscript{81}

- All affiliates that satisfy the definition must be disclosed in Item 1, including foreign affiliates.\textsuperscript{82}

- **Item 3 (Litigation)** requires disclosure of certain litigation involving (i) a predecessor; (ii) parents or affiliates that induce sales of franchises by providing the franchisor with financial backing or otherwise guarantee the franchisor's performance; and (ii) affiliates that offer franchises under the franchisor's principal trademark.\textsuperscript{83}

  - "Financial backing" is intended to refer to promises that a parent may make to ensure that the franchise system is and remains on stable financial footing. This would include a parent's promises to infuse the franchisor with cash or other assets or to extend credit, if needed, or to pay debts to third parties on behalf of the franchisor. In such a case, the franchisor or its parent induces franchise sales by representing that the purchase of a franchise is a safe investment because the parent will directly or indirectly pay third-party debts – thereby keeping the franchise system financially stable – if the franchisor cannot make such payments itself.\textsuperscript{84}

  - A guarantee of performance "refers to promises made between the franchisor's parent and the franchisor for the benefit of franchisees or from the franchisor's parent directly to franchisees. Typically, this means that the parent promises to perform obligations to franchisees that the franchisor has undertaken in the franchise agreement, if the franchisor is unable to do so. In such a case, the parent induces franchise sales by promising to fulfill the franchisor's obligations to franchisees, if the franchisor cannot perform such obligations itself.\textsuperscript{85}

  - Franchisors are required to make a reasonable effort to obtain updates of predecessor litigation that is required to be disclosed but if it cannot obtain the information from the predecessor or publically available sources like court dockets, it may note that fact in Item 3.\textsuperscript{86}

\begin{itemize}
\item \textsuperscript{81} Section 1.2 of the NASAA Commentary.
\item \textsuperscript{82} Section 1.4 of the NASAA Commentary.
\item \textsuperscript{83} 16 C.F.R. §436.5(c)(1).
\item \textsuperscript{84} FAQ #16.B. Although not expressly stated in the FAQ, the reference to “inducing sales” implies that the promises are made to prospective franchisees.
\item \textsuperscript{85} *Id.* FAQ #16.B. uses the term “parent” when describing the terms “financial backing” and “guaranteeing performance”. The disclosure obligation extends to both parents and affiliates who induce sales by financially backing or guaranteeing the performance of the franchisor.
\item \textsuperscript{86} Section 3.2 of the NASAA Commentary.
\end{itemize}
• **Item 4 (Bankruptcy)** requires disclosure of bankruptcies in the last 10 years of any parent, predecessor and affiliate.\(^{87}\)
  
  o The FTC Staff has clarified that parent bankruptcy disclosure under Item 4 bankruptcy disclosures for parents is intended to be consistent with the Item 1 definition of "parent," so that if any parent disclosed in Item 1 has had a bankruptcy during the relevant period, it must be disclosed in Item 4.\(^{88}\) Commenting on the requirement, the Statement of Basis and Purpose states that "information about predecessors and parents is material and should be disclosed. Where a parent is in bankruptcy, for example, its assets include any franchisor-subsidiary. Under such circumstances, a prospective franchisee should be made aware that the franchisor in which it is considering investing might be sold, possibly to a competitor or to a company lacking prior franchise experience."\(^{89}\)

• **Items 5 and 6 (Initial Fees and Other Fees)** require disclosure of initial franchise fees and ongoing fees payable to or imposed or collected by any affiliate.\(^{90}\)

• **Item 7 (Estimated Initial Investment)** requires the franchisor to disclose who receives payments for estimated initial investments. This may include the franchisor's parents and affiliates. If an affiliate will finance part of the initial investment, Item 7 also requires the franchisor to disclose the terms of the financing.\(^{91}\)

• **Item 8 (Restrictions on Sources of Products and Services)** requires disclosure:
  
  o As to whether an affiliate is an approved supplier (or the only approved supplier) of any product or service for establishing or operating the franchise,\(^{92}\), and

  o Of annual revenue (for the prior year) received by affiliates based on sales of products or services to franchisees.\(^{93}\)

• **Item 10 (Financing)** requires disclosure of the terms of any financing arrangements (including leases and installment contracts) offered to franchisees by affiliates must be disclosed.\(^{94}\)

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87 16 C.F.R. §436.5(d)(1). The disclosure covers voluntary or involuntary bankruptcies filed by or against the named entity as debtor and any discharges received. Additional disclosures are required for individuals.

88 FAQ #16.C.


90 16 C.F.R. §436.5(e). (f).

91 16 C.F.R. §436.5(g).

92 16 C.F.R. §436.5(h)(2).

93 16 C.F.R. §436.5(h)(6)(iv)).
• **Item 12 (Territory)** requires the franchisor to disclose:
  
  o An affiliate's use or reservation of the right to use other channels of distribution to sell within the franchisee's territory under the franchisor's marks or other marks.\(^{95}\), and

  o If affiliates operate or franchise (or have plans to operate or franchise) a business under a different trademark that will sell goods or services similar to those offered by the franchisee, what those goods and services are; the other trademark; whether the outlets will be franchisor owned or operated; whether that different trademark will be used in the franchisee's territory; if only a plan, the timetable for the plan; how conflicts will be resolved; and whether the other business will have separate physical offices and training facilities.\(^{96}\)

• **Item 13 (Trademarks)** Although Item 13 does not mention the term "parent" or "affiliate,"\(^ {97}\) requires franchisors to disclose currently effective agreements that limit the franchisor's rights to use or license the use of the marks. If an affiliate or parent owns the marks and licenses them to the franchisor with a right to sublicense, a brief discussion of the inter-company trademark license agreement may be required.\(^ {98}\)

• **Item 21 (Financial Statements)**
  
  o The franchisor must include parent or affiliate financial statements that satisfy Item 21 in lieu of the required franchisor financial statements if the parent or affiliate guarantees the franchisor's obligations under the franchise agreement. A copy of the guarantee must be attached to the FDD.\(^ {99}\)

  o If a parent commits to perform post-sale obligations of the franchisor or guarantees the franchisor's obligations for the direct benefit of franchisees, the parent's financial statements must be included in addition to those of the franchisor.\(^ {100}\) The FTC Staff has clarified that this requirement does not apply to an affiliate of the franchisor, unless the affiliate is a parent and commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations. The Staff also has clarified that this disclosure requirement is triggered only when the parent commits to perform post-sale obligations for the direct benefit of franchisees (not administrative and other services for the

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\(^{94}\) 16 C.F.R. §436.5(j).

\(^{95}\) 16 C.F.R. §436.5(l)(6)(i)(A), (B).

\(^{96}\) 16 C.F.R. §436.5(l)(6)(iii).

\(^{97}\) 16 C.F.R. §436.5(m)(7).

\(^{98}\) 16 C.F.R. §436.5(m)(7).


\(^{100}\) 16 C.F.R. §436.5(u)(1)(v).
franchisor’s internal purposes), the performance or guarantee relates to more than an isolated obligation, and the arrangement is a formal one between the parent and the franchisor or between the parent and franchisees. 101 These clarifications are consistent with the underlying policy behind the requirement: “To the extent that a prospective franchisee is asked to rely on a parent to perform post-sale contractual obligations, or relies on a parent’s guarantee, the financial stability of the parent becomes a material fact that should be disclosed.” 102

2. Practice Tips

- Know the scope of the relevant terms for each FDD item in which they are used.
- Develop questionnaires or other tools to educate clients on the different uses of the terms and how those differences impact the required disclosures.

III. DISCLOSURES IN CHALLENGING ECONOMIC TIMES

This paper does not contain a comprehensive list of all of the possible concessions, workarounds, or additional incentives that may be offered by a franchise system during financially troubled times in order to maintain franchisee interest or franchisor competitive edge or viability. The potential concessions or franchise system changes are virtually limitless. In some cases, they are industry specific. However, the observations contained here regarding the scope of disclosure may be logically extended to most types of accommodations, and this paper focuses on the most common types of changes that have taken place in the last couple of years.

A. Franchisor Concessions/Support

1. Types of Concessions/Support

During the last recession, franchisors offered many different types of concessions and support to prospective franchisees as well as to existing franchisees nearing renewal, threatening to sell or abandon their franchises, and in bankruptcy. Depending on the type of concession and whether the offer was part of a formal program, many of these deals triggered disclosure obligations in the FDD.

Typical offers to prospective franchisees include reductions or eliminations of initial franchise fees, or franchisor financing on favorable terms in instances when bank loans are unavailable. In some instances, these offers may be coupled with concessions related to training, including providing training at locations more convenient to the franchisee, and additional support or reductions in requirements surrounding grand opening programs.

The arrangements offered to prospective franchisees may be combined with support and concessions offered to existing franchisees. Among these are temporary reductions in royalty or advertising payments designed to ease financial burdens on stressed franchisees or to permit

101 FAQ #16.D.

them to lower their prices to the public and remain viable. Franchisees may also benefit from waiver or deferral of their deadlines to refresh or remodel their units, waiver of renewal fees, and waiver of other expenses and obligations. In some instances, franchisors may find ways to lower franchisee expenses by changing required suppliers or altering brand standards in ways that reduce franchisee costs of compliance.

Some franchisors also implement nonmonetary support. This can take many forms, including increased marketing support or new marketing initiatives, matched advertising dollars contributed by the franchisor, additional operational support, or heightened responsiveness to franchisee demands, such as implementation of an advisory council or granting franchisees greater autonomy over the advertising fund.

Many of these concessions are temporary, intended to last only a few months or years, and are structured as short-term modifications to the existing franchise structure. Other concessions may be more permanent, including changes to territorial limits, the restructuring of advertising fund expenditures, or modifications in the types of goods or services offered in a franchise system in response to franchisee demand.

2. Formal Program vs Ad Hoc Offers and Disclosure

The starting point for determining the required FDD disclosure is determining whether the offer is part of a formal program, or if it is an ad hoc offer. FDD disclosure of a formal program is almost always required, either because it affects the prospective franchisee directly or because the franchisee is entitled to know that fees are not uniform because of concessions made to existing franchisees.

By contrast, ad hoc offers are often treated as negotiations between the franchisee and franchisor and are not specifically disclosed. The exception is in California where negotiated sales are a required disclosure to all recipients of the FDD for the next 12 months.103 Significantly, California's negotiated sales rule does not require the negotiated changes to be filed with the Department of Corporations, meaning that although disclosure is required, no post-effective amendment is necessary.104

Care should be taken, however, to avoid improper characterization of a targeted but "one off" sales pitch as non-disclosable. Neither state examiners nor franchisees are likely to be sympathetic to a franchisor's claim that it did not disclose a new program because it only intended to offer it to a single franchisee. Where the franchisor formulates the offer in advance of a discussion with the franchisee, it is probably more of a formal program, even if it only occurs in a single instance.

Some common examples of ad hoc offers include situations in which a qualified prospect is unable to qualify for a business loan fast enough to take advantage of an ideal leasing opportunity and the franchisor extends a loan or defers payment of the initial fees in order to facilitate the transaction, or a stressed franchisee avoids bankruptcy only by reaching an

103 Cal. Corp. Code §31109.1; Cal Code of Regs. §310.100.2.

104 Id.
agreement that the franchisor will not enforce a remodeling requirement within the next two years.

In some situations, however, a franchisor may attempt to avoid disclosure of its concessions by categorizing repeated and identical offers as "ad hoc" rather than a formal program. Where there is a question about whether the program is formal or ad hoc, counsel should ask whether any franchisee who meets specific criteria will be offered specific terms. If so, the arrangement is very likely a formal program. As a best practice, these repeated and predictable offers should be disclosed in order to avoid potential franchisee claims based on various theories, including breach of the duty of good faith and fair dealing by disparate treatment.

3. Post-effective Amendment Threshold

In addition to the Rule's requirements to quarterly and annually update the FDD, many individual states require the franchisor to update the FDD in response to material changes in the system. In Maryland, section 14-220 requires the franchisor to promptly notify the Commissioner of a material change, and section 14-232 provides that it is a felony to willfully fail to do so. California Corporations Code section 31123 similarly require prompt notification in writing to the Commissioner, as well as amendment of the registration. Rhode Island likewise requires prompt amendment of the registration in response to every material change under section 19.28-1.11.

B. Other Affected Items

1. Item 1

Unless a franchise system changes its address, its ownership, or acquires a new affiliate, it is unusual for it to alter its Item 1 disclosures from year to year. A substantial financial downturn could change some related required disclosures, however, and those should be reviewed with additional scrutiny during a financial downturn.

The FTC Rule requires disclosure in Item 1 of the franchisor's other business activities, the general market for the franchised product or service, including "whether the market is developed or developing," and a description of the competition. With regard to the first of these, during any extreme economic change, the franchisor's outside business activities may cease or substantially change. In a small franchise system, this may include a substantial change in ownership interest in a related business such as a required supplier or the dissolution of related businesses. In a larger system, it may include suspension of franchise sales in other lines of business or the outright sale of another franchise brand.

Disclosures about the market for particular goods or services and about competition are typically straightforward, but in niche markets they become more complex. Quick service restaurants with value menus may find ways to thrive during an economic downturn, but the demand for luxury goods and services generally declines. In smaller markets, such as the market for pet waste cleanup, mobile beauty treatments or ultra high end hotels, an economic downturn can force some competitors out of business or cause dramatic changes in the way that the industry operates.

A temporary decline in customer demand is not itself a required disclosure. Nor do the FTC or NASAA guidelines suggest a franchisor should identify its competitors by name, so the
failure of a few competitive businesses does not necessarily trigger a change in disclosure. However, if key competitors drop out of the market or a large business enters the market in a bid to keep itself competitive in new lines of business, the franchisor should reevaluate whether its Item 1 disclosure regarding competition remains materially accurate.

2. **Item 2**

A substantial economic downturn may not only affect the number of people employed by the franchisor, but also their scope of duties. Particularly where a franchise system experiences layoffs or restructuring, the Item 2 disclosures should be examined to review the accuracy of job titles and any stated scopes of work. Corporate belt tightening may result in an increased scope of duties for employees previously excluded from Item 2, requiring them to now be included in the FDD.

In smaller systems, it is not uncommon for individuals to also hold jobs outside of the franchise. For these systems, the review of Item 2 should include specific inquiry regarding whether they continue to work in their outside jobs or have taken on new jobs, and whether any disclosed titles, roles or responsibilities in those outside businesses remain accurate.

3. **Item 3**

The FTC Rule requires the disclosure of pending or recent "material" civil actions. It also allows the exclusion of disclosure of "ordinary routine litigation incidental to the business" and civil actions that are not material by virtue of the number of franchisees, the size, nature and financial condition of the franchisor.

The FTC defines a "material" civil action as "one that is likely to influence a prospective franchisee's investment decision." In its Compliance Guide, the FTC observes that materiality must be weighed on a case-by-case basis:

For example, a civil suit by a supplier against a large franchise system with many franchisees may not be material even if the supplier were to prevail in the suit, if the amount of damages alleged would not have a materially adverse effect on the franchisor's overall financial condition. On the other hand, a civil suit for toxic dumping or stock manipulation which, if successful, may give rise to a multi-million dollar civil penalty award may be material because of its likely impact on even a large franchise system's financial condition.

In the face of declining revenues, a franchisor's monetary threshold of materiality should be reevaluated. Under the preceding example, if the franchisor has become financially unstable or vulnerable, an amount of damages that at one time would not have materially impacted the franchisor may now be a "bet the company" claim or at least one with serious repercussions for the health of the franchise system.

The FTC has also clarified that:

*All suits pertaining to the franchise relationship* -- even a small number of suits -- are presumed to be material because they may shed light on problems in the
franchise relationship or the likelihood that the franchisor will resort to litigation against a franchisee. [Emphasis supplied]105

The definition of a suit pertaining to the franchise relationship is a suit involving "contractual obligations between the franchisor and franchisee, arising directly from the operation of the franchised business." According to the FTC's definition, it does not include a suit between the franchisor and a supplier. However, in a circumstance where the outcome of a supplier action may be material to the franchise system's use of a key service or good, this action would undoubtedly be material.

Likewise, where a franchisor is subject to many times the volume of "ordinary" litigation as a result of an economic crisis, the cumulative effect of those suits may be material. In addition, during periods of broad economic uncertainty, such as the recent recession, it is likely that most franchisees would assert that their risk tolerance is reduced. Accordingly, measured against the yardstick of what would influence a franchisee's investment decision, the materiality of even minor claims is probably somewhat enhanced.

4. Item 4

Bankruptcy disclosures are required for both the franchisor entity itself and for related entities and persons identified in Item 2 for the 10 year period prior to the date of the FDD. As a preliminary matter, if new individuals are added to Item 2 as a result of changed scopes of work within the franchisor organization, the franchisor should ensure that they are informed of the requirement to disclose personal bankruptcies and the required disclosures are solicited.

As a best practice, the franchisor should ensure that all individuals identified in Item 2 receive a written questionnaire asking about disclosable litigation and bankruptcies and that this questionnaire is explicit that personal bankruptcies for any reason must be disclosed. In some instances, individuals have failed to disclose a personal bankruptcy due to a belief that if the bankruptcy was related to a job loss or medical bills and not to business or financial mismanagement, it is not disclosable.

In addition, all affiliates and parents' bankruptcies are disclosable, not merely those which guarantee performance of the franchisor. As with individuals, the franchisor should ensure that it is making appropriate inquiries of all affiliates and parent companies and, as a best practice, obtaining a statement in writing either describing the bankruptcy or confirming that there have been none.

Finally, the franchisor should avoid trying to hide a personal bankruptcy by giving a key employee a non-managerial title. The FTC clarifies that the definition of who must be included in Item 2 (and consequently in Items 3 and 4) "focuses on actual management responsibility, instead of title."106

105 Compliance Guide, p. 36.

5. **Item 19**

This paper has discussed Item 19 substantively, above. As observed, the overarching requirement of any financial performance representation is that it is not misleading. The Rule states in pertinent part, "If the franchisor makes any financial performance representation to the prospective franchisees, the franchisor must have a reasonable basis and written substantiation for the representation at the time the representation is made..." [Emphasis added.]

The Compliance Guide observes that the representation is made at the time an FDD is provided to a prospective franchisee, not at the time that the FDD is drafted or registered. This means that throughout the year, a franchisor must regulate the accuracy of its FPR and inform prospects of inaccuracies.

The amended Rule requires that, at the time of furnishing a disclosure document, any franchise seller (including any broker) must notify a prospective franchisee if the seller knows of any material changes relating to a financial performance representation. This obligation arises even if a disclosure document is furnished at a time that falls between quarterly updates. For example, a franchisor may prepare an annual update to its disclosure document that contains an Item 19 financial performance representation. A franchise broker may then furnish that disclosure document to a prospective franchisee on June 1, 2008. If the broker knows of a material change in information underlying the Item 19 representation -- such as new survey results that cast doubt on the accuracy of the Item 19 financial performance representation -- the broker must notify the prospective franchisee of that fact when furnishing the disclosure document. The term "notify" does not mean furnishing an updated disclosure document all over again. A seller may inform the prospective franchisee of the material change underlying the Item 19 in any reasonable manner, such as by letter, telephone call, or email. Of course, the franchise seller has the burden of proving that such notification was made.\[107\]

During the recent recession, many franchise systems found themselves facing dramatically fluctuating revenues among their outlets as consumers reacted to a variety of economic variables. In these circumstances, a franchisor should be constantly evaluating the validity of its FPR and whether there is still substantiation at the present moment for making that FPR. As a best practice, any material change in the bases for the FPR should be disclosed to prospective franchisees in writing at the time they are provided with the FDD. If a substantial time period has passed between the prospective franchisee's receipt of the FDD and the intended execution of a contract, the franchisor should provide updated financial information to the franchisee in order to avoid a franchisee claim that it relied on inaccurate information at the time it made its investment decision.

6. **Item 20**

The tables in Item 20 are intended to help a prospective franchisee understand both the number of franchisees in the system and the amount of turnover or attrition that the system is experiencing. Unlike several other sections of the FDD, Item 20 tables, or at least "the

\[107\] Compliance Guide, p. 129.
statistical information about franchised outlets" are intended to be updated only annually, not quarterly. However, the FTC's guidance also states that franchisors may update their FDDs more often if desired.108

In the context of Item 20, this does not mean revising the tables included in the FDD, but it does mean providing an additional statement of the changes in the system and the names of new franchisees.

In an instance where a system experiences significant attrition or turnover, in order to meet the goal of the Rule which is to inform prospective franchisees of this fact and to enable them to contact former franchisees with the most recent experience with the system, it is a best practice to provide the franchisee with an attachment to the FDD containing updated information regarding outlet turnover and any responsive contact information for current and former franchisees.

7. Item 21

Economic conditions do not affect a franchisor's obligation to furnish financial statements in compliance with the Rule's requirements, including audited financials and interim financials. However, a franchisor or the parent company which guarantees its obligations is more likely to have audited financials showing much higher liabilities, lower working capital, containing an auditor's note that there is doubt about the entity's ability to continue as a going concern, or other detrimental components. These factors are weighed heavily by examiners and may be used as the basis for refusal to register a franchise offer in a particular state or for the issuance of a financial condition such as a fee deferral or surety bond requirement under many states' laws.

The Rule permits a franchisor to substitute an affiliate's financial statements for its own in the disclosure, provided that the affiliate "absolutely and unconditionally" guarantees the obligations of the franchisor and the guarantee is provided as part of the FDD in Item 21. In the event that a franchisor has such an affiliate and the affiliate is in substantially better financial shape than the franchisor, this would be a sound approach to take in preparing the FDD.

In some instances, financially stressed franchisors opt to save money by stopping their sales process. Alternatively, some may be forced to suspend franchise sales by virtue of their own bankruptcy or such poor financial condition that they cannot obtain approval in key registration states to sell franchises. The cessation of franchise sales does not eliminate the obligation to fully comply with the Rule's audit lookback period, however. Even if a franchisor suspends its sales for a period of two years, in the third year it will be required to include audited financials for the prior two years. The "phase-in" of audited financial statements is exclusively for new franchisors and does not extend to existing, dormant franchisors.

IV. USE AND MISUSE OF EXEMPTIONS

Some may ask: Why include a section on exemptions in a paper that's focused on advanced disclosure issues? If the franchise sale satisfies the requirements of one of the FTC Rule exemptions found at §436.8 and the sale is in a non-registration state or a corresponding

registration state exemption is found, disclosure is not required. However, disclosure can be an issue in the context of an exempt offer and sale, notably where the exemption is only at the state level and only an exemption from registration, not disclosure.

A. The Current State of Franchise Exemptions

In approving the January 2007 amendments to the FTC Rule, the Commission retained four exemptions that were found in the original FTC Rule: the minimum payment exemption, the fractional franchise exemption, and the exemptions for leased departments and oral contracts. It also added new exemptions: one for relationships covered by the Petroleum Marketing Practices Act and others that include exemptions for large investments and sophisticated franchisees and for insiders. If the franchisor can establish that one of these exemptions applies, the FTC Rule and its disclosure requirements do not apply.

A number of the franchise registration states also include various exemptions in their statutes and regulations. These may be exemptions from registration and disclosure, or simply exemptions from registration, with a requirement that the franchisor continue to provide disclosure. Based on the work of the NASAA Franchise and Business Opportunities Project Group, NASAA adopted a proposed set of model exemptions for consideration by the franchise registration states in September 2012.

There are differences between the federal and state exemptions and among the various state exemptions, but for this paper, we merely note that a number of the state exemptions are exemptions only from registration, and disclosure is still required.

B. The Impact of Limited Federal Preemption

Where there is no exemption from federally required disclosure, but only an exemption from registration at the state level, the FTC Rule should control the content of the FDD, subject


110 16 C.F.R. §436.8(a)(4).

111 16 C.F.R. §436.8(a)(5)(i), (ii).

112 16 C. F. R. §436.8(a)(6).


115 See, Karen Boring Satterlee, Eric H. Karp and Adam Ekberg, NASAA’s Model Franchise Exemptions: Game Changer or Much Ado About Nothing? 32 Franchise Law Journal 191 (Spring 2013) for an in-depth analysis of the model exemptions and how they compare to current laws. This article also contains a helpful chart comparing the model exemptions to corresponding FTC Rule and state exemptions.

116 Id.
to the states’ right to require the inclusion of additional information that is more protective of prospective franchisees. Like the Original Rule, the current Rule does not fully "preempt the field of pre-sale disclosure to ensure a single, national, disclosure standard." Instead, it only preempts state law "to the extent of any inconsistency with this Rule. A law is not inconsistent with this Rule if it affords prospective franchisees equal or greater protection, such as registration of disclosure documents or more extensive disclosures." (Emphasis added.)

"Section 436.6(d) is not intended to preempt state law. As previously discussed, a franchisor can always include information in a disclosure document that is required by state law. Typically, such state disclosures will arise in two circumstances. First, state law may require specific disclosures that go beyond those required by the Franchise Rule, or may contain a broad anti-fraud provision requiring franchisors to include in their disclosure document all material information. Second, a state franchise examiner may require, as a matter of discretion, on a case-by-case basis, a particular disclosure in order to prevent deception by a franchisor. In either instance, the final amended Rule accommodates state interests by permitting a franchisor to add state information to its basic disclosure document."

But what law governs the content of the disclosure document if federal law affords a franchisor an exemption from disclosure, but state law requires disclosure or limits the exemption to registration only? Given the limited preemptive effect of the FTC Rule, it would seem that the more protective state law would govern, and one would look to the applicable provisions of that law to determine the content of the required disclosure document.

118 Id.
120 See, for example, Section 16 of the Illinois Franchise Disclosure Act of 1987: “The disclosure statement required under this Act shall be prepared in accordance with the Federal Trade Commission rule . . . 16 C.F.R. Part 436, as it may be amended, the Guidelines promulgated by the North American Securities Administrators Association, Inc., as they may be amended, and the rules adopted by the Administrator pursuant to Section 32 of this Act.” (Bus. Franchise Guide (CCH) ¶3130.16) In addition, certain state law exemptions list the items that must be disclosed to a prospective franchisee in order to claim the exemption. See, for example, Section 31101(c) of the California Franchise Investment Law. (Bus. Franchise Guide (CCH) ¶3050.25)
C. The Importance of Self-Regulation

Where offers and sales are made in registration states under an exemption from registration, but not disclosure, there may be no detailed review of the FDD to determine its compliance with the FTC Rule’s disclosure requirements. This is also true when a franchise system restricts the offer and sale of franchises to non-registration states. In those situations, franchisors must self-police and it becomes even more important that they and their counsel clearly understand and apply the FTC Rule as it has been (and is being) interpreted. Failure to exercise discipline in applying the FTC Rule’s disclosure requirements can have unexpected consequences, not the least of which may be a thorough state review of the FDD following the franchisor’s loss of a particular exemption.

V. CONCLUSION

In the more than five years since use of the amended FTC Rule disclosure requirements became mandatory for U.S. franchisors, many of the Rule’s requirements have been clarified through interpretive guidance issued by the FTC Staff and by NASAA. The FTC’s FAQs and NASAA’s Commentary, in particular, have made important contributions to our understanding of the required disclosures, including, among others, those concerning territorial protections and parent, predecessor and affiliate relationships. It is clear that it is not sufficient for practitioners simply to follow the FTC Rule when preparing an FDD. At a minimum, the additional federal and state authorities listed in the introduction to this paper must be consulted to prepare an FDD that complies with applicable federal and state laws.

But important questions remain. How do changes in the broader economy affect the scope of a franchisor’s required FDD disclosures? Do those changes or other circumstances give rise to material information that a franchisor may have an obligation to disclose, either within the FDD or outside its confines? And, if there is material information that franchisors are not permitted to include in the FDD, how are such disclosures to be made? When does a franchisor’s admonition about the risk of relying on its Item 19 financial performance representation cross the line and become a prohibited disclaimer? Does a franchisor have a reasonable basis for making an Item 19 financial performance representation based solely on historically accurate data from company-owned operations? These and other disclosure questions suggested by this paper do not always have clear answers, and in the absence of authoritative guidance, franchisors and their counsel are left to use their best judgment as to how the applicable disclosure requirements should be interpreted and applied.
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Dale has spoken at programs sponsored by the American Bar Association Forum on Franchising, the International Franchise Association, the American Franchisee Association, the Direct Sellers Association, the United States Department of Commerce, the Maryland State Bar Association, the Maryland Institute for the Continuing Professional Education of Lawyers, the New York Attorney General’s Office, the University of Maryland Law School, the U.S. Hispanic Chamber of Commerce, the Better Business Bureau, the International Franchise Expo, and the Coalition of Franchisee Associations. He also has spoken about franchise related issues to foreign delegations from Russia, Japan and China.

In 2001, NASAA presented Dale with its Outstanding Service Award for his work in franchising at the state level. In 2002, Dale testified about state franchise issues before the Commerce, Trade and Consumer Protection Subcommittee of the Energy and Commerce Committee of the U. S. House of Representatives. In 2005, the American Association of Franchisees and Dealer awarded Dale its Total Quality Franchising Chairman’s Award for Distinguished Contributions and Service to the Franchising Community.
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