PRACTICAL DISCLOSURE ISSUES UNDER THE AMENDED FTC FRANCHISE RULE: THE FINAL WORD?

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# Table of Contents

## I. INTRODUCTION

## II. KEY DOCUMENTS

## III. AMENDED FTC FRANCHISE RULE APPLICATION

A. Phase-in of the Amended FTC Franchise Rule

B. Electronic Disclosure

C. Beneficial Amended FTC Franchise Rule Changes

D. International Transactions

## IV. KEY DISCLOSURE REVISIONS UNDER THE AMENDED FTC FRANCHISE RULE

A. Use of Unaudited Financials (Amended Item 21)

B. Audited Financial Statements or Financial Statements Permitted by SEC (Amended Item 21)

C. No Broker Disclosures (Amended Item 2)

D. Litigation Filed Against Franchisees (Amended Item 3)

E. Simplified Computer Disclosures (Amended Item 11)

F. Financial Performance Representations (Amended Item 19)

G. General Media Claims ($§ 436.1(e) and 436.9(c))

H. Annual Updating ($§ 436.7(a))

I. Material Amendments ($§ 436.7(b))

J. Disclosure While Annual Updating or Material Amendment Is Being Prepared ($§ 436.7)

K. Sophisticated Investor Exemptions ($§ 436.8)

L. Parent Disclosure (Amended Items 1, 3, 4 and 21)

M. Revised Item 20 Charts (Amended Item 20)

N. Previously Owned Outlets (Amended Item 20)

O. Franchisee Advisory Councils and Trade Association (Amended Item 20)
I. INTRODUCTION

This paper will address practical disclosure issues that franchise practitioners may face when preparing disclosure documents under the Amended FTC Franchise Rule and how to comply with related state policies and implementation procedures. The paper will also discuss how the new disclosure requirements may affect structuring of the business model, the Franchise Disclosure Document, and the franchise agreement and related documents.

The amendments to the Federal Trade Commission’s Trade Regulation Rule entitled “Disclosure Requirements and Prohibitions Concerning Franchising,” 16 C.F.R. Part 436, became effective July 1, 2007 (“Amended FTC Franchise Rule”). The official version of the Amended FTC Franchise Rule can be found in the Federal Register, Vol. 72, No. 61 at pages 15444-15563 (March 30, 2007). Permission to use the original FTC Franchise Rule, which includes use of a Uniform Franchise Offering Circular (“UFOC”), will continue until July 1, 2008. On and after that date, all franchisors must comply with the Amended FTC Franchise Rule only.

Essentially, the FTC adopted a modified version of the current Uniform Franchise Offering Circular Guidelines (1993) (“UFOC Guidelines”) as the Amended FTC Franchise Rule. Most of the Amended FTC Franchise Rule will be very familiar to experienced practitioners because the FTC adopted the basic disclosure requirements of the UFOC Guidelines as the new federal disclosure standard, with several tweaks. The Amended FTC Franchise Rule adds and/or expands upon some disclosures not in the UFOC Guidelines, while also omitting a few UFOC Guidelines requirements. With the adoption of these amendments, franchise practitioners will need to focus not only on the changes in the Amended FTC Franchise Rule, but also on state reactions to the amendments and further revisions at the state level.

Is this the final word? Probably not. It is unlikely that we will have the final word until all franchisors are compelled to comply with the Amended FTC Franchise Rule on July 1, 2008, and the states have adapted their practices and procedures to the Amended FTC Franchise Rule.

Portions of this paper may be out of date by the time the Forum is held in October, but any developments between the date this paper was written and the annual Forum will be reviewed and discussed at the oral presentation.

II. KEY DOCUMENTS

Franchise practitioners have available a variety of resources to help them prepare a Franchise Disclosure Document that complies with the Amended FTC Franchise Rule. As of the date of this paper, those resources include:

1 The authors wish to acknowledge the contributions of John Baer’s colleagues at Sonnenschein Nath & Rosenthal LLP in the preparation of this paper: Rochelle Buchsbaum Spandorf, Beata Krakus and Janet Reyes.
2 Mr. Toporoff’s remarks are his own and are not being made on behalf of the Federal Trade Commission or any individual Commissioner. The opinions and observations expressed in this paper by Ms. Harris-Horn are those of Ms. Harris-Horn and are not necessarily representative of the Illinois Attorney General's Office nor the other authors of this paper.
4 See Bus. Franchise Guide (CCH) ¶¶ 5750-5860.
5 This paper was completed on August 15, 2007.


3. The FTC’s Frequently Asked Questions, known as “Amended Franchise Rule FAQs”: See http://www.ftc.gov/bcp/franchise/amended-rate-faqs.shtml (“FAQs”). A copy of the FAQs is attached to this paper as Appendix A.

4. FTC Staff Advisory Opinions: will be published in the Bus. Franchise Guide (CCH). (Note: the FTC is currently using the FAQs to respond to inquiries rather than issuing staff advisory opinions.)

5. State franchise registration and disclosure law statutes and regulations (as amended or unamended): See Bus. Franchise Guide (CCH) ¶¶ 3000 to 3520, and ¶¶ 5050 to 5490.


We anticipate that the FTC, NASAA and/or the individual states may issue further clarifications and revisions after the date of this paper. For example, the FTC plans to issue Guidelines at some point in the future.

III. AMENDED FTC FRANCHISE RULE APPLICATION

This portion of the paper will address the practical issues that may arise, or may have already arisen, as a result of the application of the Amended FTC Franchise Rule.

Note: Until July 1, 2008, there will be two versions of 16 C.F.R. Part 436 (the original FTC Franchise Rule and the Amended FTC Franchise Rule). So the reader will not become confused, the citation format in this paper will generally follow the same approach the FTC used in its Statement of Basis and Purpose:

1. When we cite the original FTC Franchise Rule, we will cite 16 C.F.R. and the Section number. For example, “16 C.F.R. § 436.1.”

2. When we cite the Amended FTC Franchise Rule, we will cite only the Section number. For example, “§ 436.1”.

3. References to an amended Item in the Amended FTC Franchise Rule will be cited as, for example, “Amended Item 1”, and the Section reference to the Amended FTC Franchise Rule (as explained in paragraph 2) will be shown in a footnote.
A. Phase-in of the Amended FTC Franchise Rule

Although the Amended FTC Franchise Rule became effective July 1, 2007, franchisors have until July 1, 2008 to comply. One crucial factor the reader should understand as we discuss the Amended FTC Franchise Rule is that, with only one exception relating to electronic disclosure, a franchisor can take advantage of the changes in the Amended FTC Franchise Rule only after it prepares or rewrites its disclosure document in the Amended FTC Franchise Rule format. Until July 1, 2008, franchisors are given the choice of using the original FTC Rule format, the UFOC Guidelines format or the Amended FTC Franchise Rule format. The elements of the different formats may not be combined in a single disclosure document. The franchisor that chooses to continue complying with the original FTC Franchise Rule on and after July 1, 2007 must maintain such compliance until it converts formats.6

For start-up or new franchisors, most franchisors likely will prepare a Franchise Disclosure Document that complies with the Amended FTC Franchise Rule. However, start-up or new franchisors have the option of preparing a disclosure document that complies with the original FTC Franchise Rule or the UFOC Guidelines, as long as they convert the disclosure document to the Amended FTC Franchise Rule format before or on July 1, 2008.

For existing franchisors, the choice is whether to convert now or wait until closer to the July 1, 2008 deadline. There is no right or wrong answer. To a large extent, the FTC anticipates that most revisions will be driven by the franchisor’s fiscal year end and the preparation of their annual updates,7 with most franchisors having a December 31 fiscal year end.

Assuming a franchisor sells in both registration and non-registration states, conversion to the Amended FTC Franchise Rule format conceivably could occur at different times. Since we do not know when each registration state will modify its law or regulations to implement the Amended FTC Franchise Rule -- and state implementation dates are likely going to vary considerably -- for the short term, franchisors certainly could consider using two disclosure documents. For example, a franchisor could convert its UFOC to the Amended FTC Franchise Rule format and use it for sales in non-registration states only, and could continue to use its current pre-converted UFOC in each registration state until the state implements the Amended FTC Franchise Rule and the additional disclosures, if any, that will be required. This would be permissible because each disclosure document is distinctly one format without mixing and matching. The franchisor can use different documents in different states as long as each document stands on its own.

Based on the recently issued NASAA Statement of Policy, the states will register a material change amendment (known as a “material amendment” by the state examiners) with a UFOC converted to the Amended FTC Franchise Rule format even before the state has adopted its own implementing rules. That being the situation, the use of two separate disclosure documents may not be cost effective, desirable or effective.

There are three more likely, but different, “migration” scenarios for franchisors adopting the Amended FTC Franchise Rule format: (1) companies with a calendar fiscal year-end,

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6 FAQs, Question 1.
7 FAQs, Question 6.
(2) companies with a fiscal year ending between July 1 and December 31, and (3) companies with a fiscal year ending between January 1 and June 30.

First, for the franchisor with a December 31 fiscal year-end, when is the best time to migrate to the Amended FTC Franchise Rule’s disclosure format? The franchisor has choices: (i) convert its disclosure document at any time after July 1, 2007 by filing a material amendment, or (ii) wait to convert until the 2008 renewal season when it will make its other fiscal year-end updates.

A significant advantage of making the conversion as part of an earlier material amendment is that the franchisor may be able to avoid the extremely hectic filing season that runs from late February through May each year. This is a time when state examiners receive literally hundreds of renewal filings, so the franchisor will be competing for attention with a long line of applicants.

State examiners will likely process renewal applications more slowly next year, so rather than risk a registration expiration until the state examiners process a renewal application, the franchisor may wish to convert earlier. Then, when the renewal application is filed, fewer changes should result in an expedited renewal process. Note: There is an expiration exception in Illinois which provides for continuity of registration if the franchisor timely files its renewal/annual report.8

If a franchisor decides to make the conversion by means of a material amendment, early January, 2008 may be a good time to file. By then, the franchisor should be familiar with the basic components of the Amended FTC Franchise Rule, thereby easing the rewrite process while avoiding being caught in the flood of renewal applications that start flowing into the states by late February.

Another advantage of a material amendment is that the franchisor can timely complete the conversion process while avoiding potential auditor delays should its auditors be late in completing the December 31, 2007 fiscal year-end audit. The disadvantage, of course, of converting by a material amendment is the extra cost of preparation time and filings fees. These costs should be offset by a simplified preparation of the franchisor’s 2008 renewals.

Second, if the franchisor’s fiscal year-end falls between July 1 and December 31, when is the best time to migrate? For purposes of this discussion, assume that its fiscal year ends on September 30, which means its fiscal year end updates are due in January, 2008.

Franchisors with fiscal year-ends that fall between July 1 and December 31, such as in the September 30 example above, may want to make the conversion with their fiscal-year end updates. Because of the renewal crush, a material amendment anytime after late February, 2008 would likely result in delayed review. Unlike renewal applications, material amendments receive no filing priority and are often relegated to the bottom of a state examiner’s pile. Another consideration is a second flurry of applications expected in June, 2008, from franchise companies that wait until the last minute to convert to the Amended FTC Franchise Rule format. Consequently, a franchisor whose fiscal year end falls between July 1 and December 31 may want to opt for conversion when filing its next fiscal year end update.

8 Illinois (§ 12); Bus. Franchise Guide (CCH) ¶ 3130.12.
Third, if the franchisor’s fiscal year-end falls between January 1 and June 30, what is the best migration strategy? For purposes of this discussion, assume the fiscal year ends on the last Saturday of June and the franchisor’s updates are due in October. The franchisor may not be prepared to convert with the fiscal year end update in October, 2007, and it cannot wait until the following 2008 fiscal year end update to convert since the Amended FTC Franchise Rule becomes mandatory on July 1, 2008. In this situation, the franchisor will probably make the migration by a material amendment subsequent to the filing of the annual renewal or its annual report. In this scenario, the franchisor should avoid filing the amendment during the spring crush.

Regardless of the timing of the filing, most likely applications will take longer than usual to process during the next 12 months. As you move forward with the conversion process, keep in mind Dale Cantone’s announcement to the Forum’s list serve about the adoption of the NASAA Statement of Policy, which ended with this caution: “- Be patient.”

B. Electronic Disclosure

As noted before, the one change a franchisor can take advantage of now, even though it has not switched to the Amended FTC Franchise Rule format, is the use of electronic disclosure. Because electronic disclosure is a method of delivery and does not affect substantive disclosure requirements, the FTC has stated that, for FTC purposes, all franchisors can begin using electronic disclosure on July 1, 2007. There are four key issues relating to electronic disclosure.

First, will the registration states permit electronic disclosure? California and Indiana have adopted formal provisions allowing electronic disclosure. Legislation enacted by the California legislature on July 9, 2007, and approved by the Governor on July 20, 2007, will expressly allow electronic disclosure pursuant to rules or orders of the Commissioner. Other states have not adopted specific laws or regulations, but we believe they have tacitly accepted NASAA’s policy on electronic disclosure and will accept electronic disclosure. Another consideration is the federal E-Sign Act, which may preempt the states on this point. In any case, it is not anticipated that any franchise registration state will oppose e-disclosure, and some states may actually look forward to this technological advance in franchising.

Second, does the electronic disclosure document have to be exactly like the hard copy document? Should it be a PDF file? Can you use electronic enhancements? Essentially yes to the first two questions, and an unequivocal no to enhancements. Enhancements such as audio, video, pop-ups and external links to your web site are prohibited in an effort to assure the

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9 Dale Cantone e-mail to Forum on Franchising list serve, June 27, 2007.
10 FAQs, Question 2.
12 California (Regulation § 310.114.4, effective March 2, 2006); Indiana (Statement of Policy adopted October 25, 2005); Bus. Franchise Guide (CCH) ¶¶ 5050.24, 5140.06.
continued integrity of the disclosure document. However, the Amended FTC Franchise Rule will allow limited electronic enhancements, such as scroll bars, search features and internal links to facilitate franchisee navigation of the document. Everything else is not permitted.\textsuperscript{16}

Third, how does a franchisor disclose electronically? There are a multitude of options available to the franchisor: e.g., e-mail, a password protected Internet site or CD-ROM. E-mail probably will be the favored option because it is inexpensive, efficient and simple. To ensure that a franchise prospect realizes that alternative disclosure formats are available, the franchisor may add information to the cover page of the disclosure document identifying such alternative formats -- either electronic or hard copy.\textsuperscript{17} Note that the cover page provision is optional, and not required of the franchisor by the FTC.

Fourth, how does a franchisor control e-disclosure? With all the freedom that e-disclosure gives, there comes responsibility. A franchisor may discover that by using e-disclosure it will end up disclosing more people earlier in the sales process because it is so easy to do. But the franchisor still needs to track, very carefully, who was disclosed and when. Also, remember that no matter how early a franchisor discloses a prospect, the 14 calendar-day count begins the day after receipt of the disclosure document -- it does not begin to run on the day when the franchisor e-mails the disclosure document.\textsuperscript{18}

To ensure ongoing compliance, franchisors should create an e-delivery protocol that tracks all disclosure documents they release, just like and similar to the system franchisors have implemented for hard copy versions. Delegate to one or two key employees the responsibility and authority to electronically deliver the disclosure document and collect executed receipt pages by e-mail, PDF, fax or mail.

To further facilitate a total e-process, the Amended FTC Franchise Rule defined “signature” to mean a person’s affirmative step to authenticate his or her identity, and specifically included a person’s handwritten signature, “as well as a person’s use of security codes, passwords, electronic signatures, and similar devices to authenticate his or her identity.”\textsuperscript{19} In the spirit of technological advancement, the franchisor establishing a pure e-disclosure system should adopt software that will perform the noted services while also allowing access to the various forms of electronic signatures for at least the three years the franchisor is required to retain receipts. If the franchisor keeps true electronic signatures, it should make sure that it also maintains software that allows it to access those signatures.

In its FAQs, the FTC addressed the manner in which a franchisor might comply with the Item 23 receipt requirements when disclosing electronically. Section 436.6(d) prohibits franchisors from including, in any electronic disclosure document, external links to materials outside the disclosure document itself. However, the FTC staff says the limited use of an external link to a web-based receipt page (e.g., an icon, such as “submit” or “submit receipt"

\textsuperscript{16} §§ 436.2(c), 436.6(d); Statement of Basis and Purpose, §§III.D.4, 72 Fed. Reg. at 15515-15517.
\textsuperscript{17} § 436.3(f).
\textsuperscript{18} “The Commission intends that the 14 days commence the day after delivery of the disclosure document and that the signing of any agreement or receipt of payment can take place on the 15th day after delivery. That ensures that prospective franchisees have at least a full 14 days in which to review the disclosures.” Statement of Basis and Purpose, § II.B.2.b, 72 Fed. Reg. at 15469.
button on the Amended Item 23 receipt page or even on the cover page) is permissible because it is consistent with the goal of electronic disclosure and does not diminish the level of protection the amended Rule provides to prospective franchisees. An external link to a webpage accessible only to recipients of a disclosure document would facilitate compliance with the Amended Item 23 receipt requirement. The FAQ said:

Accordingly, in the opinion of FTC staff, it would not violate the amended Rule for a franchisor to include a link in the receipt page to a webpage that facilitates submission of the Item 23 receipt provided that: (1) the web-based receipt page is accessible only by prospective franchisees from Item 23 of an electronic disclosure document; and (2) no other content or external links are included in the web-based receipt other than information required or permitted by Item 23 of the amended Rule (i.e., instructions for submitting the receipt).20

Another electronic receipt page icon acceptable to the FTC is an icon on the electronic receipt page that, when pressed, would enable the prospect to print out a copy of just the receipt, which could then be signed and mailed or faxed to the franchisor. That way the prospect would not be forced to print out the entire disclosure document.

A word of caution. The FTC will not permit a franchisor to e-mail a prospect two documents: (1) the basic disclosure document, and (2) a separate receipt page that could printed out, signed and returned to the franchisor. This is not acceptable because it would be possible for the prospect to open only the separate receipt page. “In such an instance, there would be no proof that the prospect, in fact, was able to open and had the opportunity to review the disclosure document itself.”21

C. Beneficial Amended FTC Franchise Rule Changes

As noted above, except for electronic disclosure, a franchisor cannot take advantage of certain beneficial changes in the Amended FTC Franchise Rule until the franchisor switches to the amended format. Some of those changes will be reviewed.

(1) Delivery Rules

The Amended FTC Franchise Rule makes major changes to the current delivery rules. Current law requires a franchisor to deliver a copy of its UFOC at the earlier of (i) the first personal meeting, which is a “face-to-face meeting to discuss the sale of a franchise,” or (ii) at least 10 business days before a binding agreement is signed to buy a franchise or any payment for the franchise is made - even if it is a refundable deposit.22

The first personal meeting rule has always been problematic for franchisors because there is no way to know in advance if a casual meeting, for example at a trade show, might turn into a conversation about buying a franchise. The Amended FTC Franchise Rule eliminates the first personal meeting rule entirely and replaces the 10 business days disclosure with a 14 calendar-day disclosure. Now, the franchisor must furnish a prospective franchisee with a copy

20 FAQs, Question 15.
21 Id.
22 16 C.F.R. §§ 436.1(a) and 436.2(g); FTC Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule, ¶I.C.I; Bus. Franchise Guide (CCH) ¶ 6222.
of its current disclosure document at least 14 calendar-days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale.23

Other important changes regarding the delivery rules concern modified contracts and negotiated sales. The Amended FTC Franchise Rule eliminates the former 5 business day delivery rule of "execution ready" copies of the agreements.24 Now, only if the franchisor unilaterally and materially alters the terms and conditions of the basic franchise agreements, it must give the prospective franchisee a copy of the revised agreement(s) at least 7 calendar-days before the prospect signs the agreement.

Changes arising from negotiations initiated by the prospective franchisee do not trigger the 7 calendar-day cooling off period.25 Thus, if a franchisee initiates negotiations, there will be no second waiting period. Again, the 7 calendar-day redisclosure requirement applies only when the franchisor makes unilateral changes to its standard franchise contracts.

In its FAQs, the FTC addressed the issue of whether a fill-in-the-blank provision in a franchise agreement is a substantive modification. The FAQ discussed a protected territory and the initial fees.26 The FTC says that it interprets “fill-in-the-blank” provisions narrowly and, quoting from the Statement of Basis and Purpose, observed that if substantive contractual details, such as the geographic area, a protected area and interest rates, are not disclosed in the disclosure document or its attachments, including the agreements, the prospect must have 7 calendar-days to review the revised document prior to its execution.

Alternatively, protected territories can be viewed in a non-substantive light. For example, the franchisor can fill in the blank without triggering the 7 calendar-day review period if the territory was previously identified, but the exact name or circumstance was unknown at the time of disclosure, such as where a franchisor grants protected territories on a county-wide basis. Simply filling in the name of the county in the franchise agreement would not constitute a substantive change. But if the disclosure document says the territory will range from 1 to 10 miles, a later fill-in would trigger a 7 calendar-day waiting period.

Whether a change is substantive or not may depend on the manner of disclosure. The example of protected territories can generate multiple scenarios beyond those discussed in the FAQ, and requires a franchisor to use extreme caution in deciding whether the calendar-day waiting period will be triggered.

The franchisor must remember that delivery rules are not limited to the Amended FTC Franchise Rule. Stricter state delivery rules must be adhered to because the Amended FTC Franchise Rule does not preempt state law when state law provides greater protection for prospects. See the discussion in Section V.B of this paper.

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23 § 436.2(a). See Footnote 16 for a discussion of what 14 calendar-days really means.
24 16 C.F.R. § 436.1(g).
25 § 436.2(b); Statement of Basis and Purpose, § III.B.3, 72 Fed. Reg. at 15471.
26 FAQs, Question 10.
(2) New Exemptions

The FTC added three new exemptions to the Amended FTC Franchise Rule which it collectively refers to as the "sophisticated investor exemptions." However, a franchisor cannot take advantage of the new sophisticated investor exemptions until it converts its disclosure format. On the other hand, a start-up or new franchisor that has never prepared a disclosure document before can immediately take advantage of the new exemptions. Caution: no registration state currently recognizes identical exemptions.

The states have exemptions that overlap parts of these three new federal exemptions. However, state laws currently differ considerably regarding exemptions and exclusions, although the hope is that eventually all registration states will adopt the same three sophisticated investor exemptions with the identical thresholds as the Amended FTC Franchise Rule. Until the states take action, however, these new FTC exemptions will only aid franchise sales for locations in non-registration states.

If a franchisor sells franchises in both registration and non-registration states, it will still need to convert its UFOC to the Amended FTC Franchise Rule’s disclosure format and plan to use it in the various registration states until a state adopts the same exemptions. On the plus side, if the franchisor can take advantage of these new exemptions in non-registration states, those sales will not be subject to waiting period rules which can delay a franchisor’s closing.

Another benefit of exempt sales is avoidance of the restrictions that apply to Amended Item 19 claims. Of course, all information that a franchisor supplies to a prospect must be truthful and not misleading; anti-fraud rules will still apply even to exempt sophisticated transactions.

An expanded discussion of these three new exemptions appears in Section IV.K of this paper.

D. International Transactions

For the first time, the Amended FTC Franchise Rule clarifies whether it will apply to other than domestic transactions. To a large extent, the Amended FTC Franchise Rule “eases international franchising,” at least for U.S. franchisors going abroad.

With respect to outbound transactions whereby a U.S. franchisor sells franchises to operate a franchise in a different country, the FTC has finally resolved this festering issue by stating that the Amended FTC Franchise Rule applies only “in connection with the offer or sale of a franchise to be located in the United States of America or its territories.” For purposes of the Amended FTC Franchise Rule, a sale of a franchise to be operated in another country is not covered. Thus, a sale by a U.S. franchisor to anyone (another U.S. citizen or a foreign national) to operate a franchise in another country is not covered. One word of caution: If the franchisor is located in one of the 14 franchise registration and disclosure states, the franchisor

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27 § 436.8(a)(5) and (6); Statement of Basis and Purpose, § III.F.3, 72 Fed. Reg. at 15522.
29 § 436.2.
needs to check the law of that jurisdiction to see whether that state’s disclosure law would cover
the sale of a franchise to an international buyer to be operated outside the U.S.31

For foreign franchisors who want to sell franchises in the United States, it is now clear
that the Amended FTC Franchise Rule would apply to those transactions simply because the
franchise would be located in the United States. The fact that a franchisor and franchisee are
both located in foreign countries is irrelevant. If the franchise will be operated in the U.S., the
Amended FTC Franchise Rule applies.

For the impact of the FTC’s audited financial statement requirements on foreign
franchisors, see Section IV.B of this paper.

IV. KEY DISCLOSURE REVISIONS UNDER THE AMENDED FTC FRANCHISE RULE

This part of the paper will address some key revisions of the Amended FTC Franchise
Rule and practical issues that have arisen already or may likely arise. As noted above, the FTC
did not preempt existing state registration and disclosure requirements. Consequently, while
the Amended FTC Franchise Rule will be the national standard, the states remain free to
impose additional requirements provided that those requirements are not inconsistent with the
FTC requirements in the Amended FTC Franchise Rule.32

A. Use of Unaudited Financials (Amended Item 21)

Amended Item 2133 provides that a start-up franchise system that has not prepared
audited financial statements may phase-in the use of audited financial statements by providing,
at a minimum,

(1) An unaudited opening balance sheet for first partial or full fiscal year
    selling franchises;

(2) An audited balance sheet as of the end of the first partial or full fiscal year
    selling franchises for the franchisor’s second fiscal year selling franchises;

(3) All required financial statements (audited) for the previous fiscal year,
    plus any previously disclosed audited statements, for the franchisor’s third
    and subsequent fiscal years selling franchises.

Unaudited statements must be in a format that conforms as closely as possible to
audited statements. The franchisor may also need to clearly and conspicuously disclose that it
has not been in business for three or more years and cannot include all required financial
statements.

In its FAQs, the FTC addressed the use of unaudited financials, saying there is no
requirement that the opening balance sheet be prepared by an accountant. However, the FTC

31 See John Baer, Ken Costello, Gary Duvall, Joyce Mazero and Eric Wulff, “Application of U.S. Franchise Laws to
33 § 436.5(u).
expects the franchisor's management to look to GAAP for guidance so that the opening balance sheet would be in the form of a typical balance sheet prepared under GAAP and to include explanatory notes, where warranted, to ensure that the balance sheet is clear and accurate. To avoid confusion, the franchisor must clearly and conspicuously note that the balance sheet is unaudited.  

While this revision will be invaluable to many start-up franchisors, a number of the registrations states have not accepted unaudited opening balances sheets, and the franchisor will likely still need to use an audited opening balance sheet in those states. For those states accepting unaudited balance sheets (e.g., Illinois), other issues remain. For example, will an independent auditor be required to prepare the financial data? Must a corresponding profit and loss statement be submitted? Without the income statements, how will the franchise prospect and/or its advisors determine whether the franchisor's financial activities have had a positive or negative effect on its financial condition?

B. Audited Financial Statements or Financial Statements Permitted by SEC (Amended Item 21)

Under Amended Item 21, the FTC will allow the use of financial statements prepared according to U.S. generally accepted accounting principles (“GAAP”), as revised by any future U.S. government mandated accounting principles, or “as permitted by the Securities and Exchange Commission” (“SEC”). These financial statements must be audited by an independent certified public accountant using generally accepted U.S. auditing standards. Whether the use of SEC permitted financial statements will benefit private companies as well as public companies remains unclear.

The FTC will continue to permit franchisors to include the financial statements of affiliates if those financial statements are prepared as noted above and the affiliate “absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement.” If this alternative is used, the FTC requires a copy of the guarantee to be attached to the disclosure document.

The FTC added a new requirement: separate audited financial statements for any parent that “commits to perform post-sale obligations for the franchisor or guarantees the franchisor’s obligations” must be included in the disclosure document. There is a more detailed discussion of the impact of this provision in Section III.L below on “Parent Disclosure” issues.

While the FTC amendments will have a limited impact on most U.S. companies, questions remain as to whether these FTC amendments will benefit foreign franchisors. Requirements with respect to U.S. GAAP have prompted many foreign franchisors to establish a U.S. subsidiary to engage in franchising operations, using separate financial statements for the subsidiary compliant with U.S. GAAP preparation methods. This has long been a viable option for the U.S. subsidiary and its foreign parent. However, as we will discuss below in Section III.L of this paper, if the foreign parent agrees to provide post-sales services to the

34 FAQs, Question 11.
35 § 436.5(u).
36 § 436.5(u)(1)(iii)
37 § 436.5(u)(1)(v)
franchisees of that U.S. franchisor subsidiary, the foreign parent’s audited financials would also have to be attached to the franchise disclosure document and its litigation reported in Item 3. These new financial disclosure requirements with respect to post-sale obligations will likely force the foreign parent and its U.S. subsidiary to reexamine the method of operation and determine their options. Restructuring may be the consequence.

For those same foreign franchisors, there may be hope, albeit on a distant horizon, that their financial statements may be usable some day. On June 20, 2007, the SEC voted to allow companies outside the U.S. to file financial results using international reporting standards ("IFRS") as set by the International Accounting Standards Board, without reconciling the figures to U.S. GAAP and highlighting the differences, as is now required. The SEC is also exploring whether U.S. companies should be permitted to file financial statements under U.S. GAAP or the international alternatives.38

On July 2, 2007, the SEC issued a proposal entitled “Acceptance From Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation To U.S. GAAP.”39 Under this proposal, the SEC would accept financial statements of foreign private issuers that are prepared on the basis of the English language version of the International Financial Reporting Standards as published by the International Accounting Standards Board without requiring reconciliation to U.S. GAAP. Comments are being accepted until September 24, 2007, and any finalization of the proposal is likely a year or two off. For foreign franchisors, this proposed SEC rule would be very helpful because the FTC has indicated that it would accept such financial statements.

Another financial issue for foreign franchisors is whether those entities need to employ a U.S. accounting firm to prepare their financial statements. Generally, the answer is yes. But, if a foreign accountant is able to provide financial statements to the SEC, or otherwise prepare such statements under U.S. GAAP methods, then the statements prepared by those foreign accountants should be acceptable for the disclosure document. A major concern, however, is that the state franchise examiners may not comprehend this issue very well (does anyone in franchising?), so a foreign franchisor using financial statements prepared by a non-U.S. accountant may encounter some push-back from the states, even if those financial statements are prepared in accordance with U.S. GAAP.

C. No Broker Disclosures (Amended Item 2)

Franchisors should view as a positive change in the Amended FTC Franchise Rule the elimination of the broker disclosure requirement in Amended Item 2.40 However, the industry is unsure on how the states will respond to this and whether they will agree on the omission of such data.

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40 Broker disclosure was required by Item 2 of the UFOC Guidelines. It was not required by the original FTC Franchise Rule. See 16 C.F.R. § 436.1(a)(2); Statement of Basis and Purpose, §III.B.4, 72 Fed. Reg. at 15475-15476.
Two states, Illinois \(^{41}\) and Washington, \(^{42}\) require an annual broker registration, and New York requires a one-time registration of “franchise sales agents”. \(^{43}\) We do not know at this time whether those states will continue to require broker disclosure in Item 2. Note: even though broker disclosure may no longer be required in Item 2, the broker will need to be listed on the Receipt pages because the Amended FTC Franchise Rule requires the Receipt pages to identify all “franchise sellers”. See discussion below in Section IV.R of this paper.

D. **Litigation Filed Against Franchisees (Amended Item 3)**

Amended Item 3 \(^{44}\) will require franchisors to disclose material franchisor-initiated litigation against its franchisees. Fortunately, the disclosure requirements for franchisor-initiated litigation are more lenient than the remainder of Amended Item 3. A franchisor will only have to disclose actions that the franchisor filed during its last fiscal year - not the last 10 years. The franchisor will also be able to categorize these actions into subgroups such as “failure to pay royalties”, or “breach of quality control” -- and will not have to give a full description of the cases -- just the case name, number and court. These disclosures only need to be updated annually. \(^{45}\)

One caveat: If a franchisee files a counter-claim against a franchisor in a franchisor-initiated case, the counterclaim will be treated as any other franchisee-initiated action and the regular, full disclosure will be required.

Although it is not clear how this new obligation will affect franchisors, one franchise lawyer suggests that franchise litigators will spend more time assisting their transaction colleagues in preparing disclosures, and that may change the way a franchisor decides to conduct litigation. \(^{46}\)

E. **Simplified Computer Disclosures (Amended Item 11)**

Amended Item 11 \(^{47}\) still requires the franchisor to disclose whether the franchisee is required to buy or use electronic cash registers or computer systems. If so, then general, non-technical descriptions of the systems must be provided. The disclosure must state: (1) the cost of purchasing or leasing the system; (2) any obligation of the franchisor, affiliate or third-party provider to provide ongoing maintenance, repairs, upgrades or updates; (3) any obligations of the franchisee to upgrade or update the system, frequency of updates and costs; (4) annual cost of optional and required maintenance, updating, upgrading or support contracts; and (5) whether the franchisor will have independent access to the generated or stored information.

\(^{41}\) Illinois (§ 13); Bus. Franchise Guide (CCH) ¶3130.13.
\(^{44}\) § 436.5(c)(1)(ii).
\(^{45}\) Statement of Basis and Purpose, § III.A.5.e, 72 Fed. Reg. at 15480-15483.
\(^{47}\) § 436.5(k)(5).
The FTC reasoned that the compliance burdens to prepare component-specific disclosures would not likely outweigh any tangible benefits to prospective franchisees. This revision will be helpful to franchisors who may not have decided on specific systems at the time of sale or, even if they did, where the technology may change over the course of the franchise agreement. This is an especially useful revision, reducing computer disclosures under the UFOC Guidelines by multiple pages, as well as eliminating disclosure of quickly outdated hyper-technical detail that only a few people could appreciate (or even understand).

F. Financial Performance Representations (Amended Item 19)

“Earnings claims” are seldom given in a disclosure document, but (many would say) are often discussed. They are clearly a potential violation trap for franchisors who do not include them in their disclosure documents.

The first Amended Item 19 change was the re-labeling of the phrase “earnings claims” to “financial performance representations.” Overall, the other changes to Amended Item 19 were designed to encourage more franchisors to make financial performance representations.

There are three things that franchise companies should know about the changes. First, the FTC considered, but rejected, the idea of mandating that all franchisors make a financial performance disclosure. Amended Item 19 “financial performance representations" remain voluntary.

Second, Amended Item 19 excludes cost-only data or expenses from the definition of a financial performance representation. The FTC believes that expense information alone will not enable a prospect to determine potential earnings. Consequently, a franchisor is now free to supply prospects with more detailed cost and expense information than is currently available via UFOC Item 7 or Amended Item 7. This new position presents some very interesting possibilities for franchisors as well as enhanced disclosure for franchise prospects.

Item 7 describes low/high ranges of a franchisee’s initial investment. For many companies, this range is very broad because they want to make sure the upper end of the initial investment covers the most expensive build-out scenario. For example, consider a dinner concept restaurant franchise that sells franchises in all 50 states using one UFOC with a state addendum -- which is the approach most franchisors follow. The franchisor’s UFOC might have a very broad low/high estimated initial investment in Item 7, with a high estimate for real estate or rental costs in expensive cities like New York City or San Francisco. A prospect looking to open in Albuquerque, who is planning conservatively, may also believe that his rent could be at the upper edge. By excluding cost data from Amended Item 19, a franchisor may be able to provide the Albuquerque prospect with rental rates tailored to his/her market. This should help a franchisor present its program more accurately, as well as more competitively, to prospects who are shopping around.

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49 § 436.5(s).  
51 § 436.1(e); Statement of Basis and Purpose, §III.A.5.a, 72 Fed. Reg. at 15436.  
52 § 436.5(g).
A franchisor will be able to be creative when supplying expense-only data. For example, if a franchisor wants to provide separate individualized cost data to a prospect, there are no time limits with respect to such data. The franchisor will be able to provide the prospect with the historical expense data for all Albuquerque franchises, or just those in business for a year or another period of time. However, the franchisor must remember that it cannot couple expense information with different for sales and/or revenue scenarios. Expense information falls outside of Amended Item 19 only if it does not incorporate top line or net data.

Caution: a franchisor cannot begin using cost-only data until it converts to the Amended FTC Franchise Rule disclosure format. Although the states have yet to decide if they will adopt the Amended FTC Franchise Rule or a similar format, we anticipate that the states will likely accept the FTC’s approach of excluding expense-only data from disclosure regulation.

Third, Amended Item 19 now allows franchisors to make a financial representation -- which must be in the disclosure document -- based on a defined subset of outlets that share a particular a set of characteristics. A subset may be a specific geographic market, such as Albuquerque in the example above, with the franchisor providing financial data for all Albuquerque restaurants larger than 5,000 sq. ft that have been operational for at least 5 years.

In making this change, Amended Item 19 departs from Item 19 of the UFOC Guidelines in two significant ways. No longer must Amended Item 19 disclosures be (1) geographically relevant to the particular prospective franchisee, and (2) inaccurately analogous comparing subset franchise data to all franchisees in a system. The FTC found that both of these requirements discouraged franchisors from making financial performance representations, with the FTC actually encouraging franchisors to provide earnings data.

Finally, in connection with subsets, a question has been raised whether affiliates count as a subset. In its FAQs, the FTC said that when a franchisor has adequate performance data of its own on which to base a performance representation, basing it on affiliate information would not be reasonable. However, the Amended FTC Franchise Rule allows franchisors to use affiliate information in certain narrow circumstances: “when the franchisor lacks an adequate operating experience of its own”. The franchisor must disclose any characteristics of such outlets that may differ materially from outlets being offered for rule.

G. General Media Claims (§§ 436.1(e) and 436.9(c))

The FTC’s long standing policy on general media claims is embodied in four different provisions of the Amended FTC Franchise Rule:

(1) Section 436.1(e), where the definition of financial performance representation, specifically includes “a representation in the general media”;  

(2) Section 436.9(c), which prohibits dissemination of any financial performance representation unless the franchisor has a reasonable basis and written
substantiation, and the claim is included in Amended Item 19, applies equally to
general media claims;\(^{56}\)

(3) Section 436.9(c)(1) which provides that a past representation (e.g., in an
advertisement) must include information from Amended Item 19, specifically the
dates when the reported level of financial performance was achieved, numbers
and percentage;\(^{57}\) and

(4) Section 436.9(c)(2) which requires a clear and conspicuous admonition that
individual financial results may differ from the results stated in the financial
performance representation.\(^ {58}\)

Taken together, these four sections reflect the FTC's long standing policy on general media
claims. The only thing that has changed is the scope of what is considered a general media
claim.

There is an extensive discussion of general media claims in the Statement of Basis and
Purpose.\(^ {59}\) The FTC narrowed financial performance representations to exclude performance
information online, SEC information, speeches and news releases. The FTC also distinguished
between advertisements directed to franchisees in print, radio, television or the Internet, from
those disseminated to the general public. However, if a franchisor uses any financial data in
materials or on a website directed towards franchise prospects, then it is considered a general
media financial performance representation and would trigger the disclosure requirements of the
Amended FTC Franchise Rule.

H. Annual Updating (§ 436.7(a))

All information in the disclosure document has to be current as of the close of the
franchisor's most recent fiscal year. The Amended FTC Franchise Rule requires a franchisor to
prepare a revised disclosure document within 120 days after the close of its fiscal year.\(^ {60}\)

Until the states change their annual renewal procedures, a franchisor will have to file its
annual update earlier than 120 days in most of the registration states. For example, in
California registrations expire 110 days after the franchisor's fiscal year end, but the franchisor
has to file 15 business days before that date (or by the end of March) to keep its place in line.\(^ {61}\)
In Hawaii, registrations expire three months after the fiscal year end.\(^ {62}\) To have a continuous
registration in Hawaii, a renewal must be filed seven days before the expiration date since
registrations are effective seven days after filing. Several states tie their annual renewals to a
period similar to the FTC: 120 days after the franchisor's fiscal year end.\(^ {63}\) The other states tie
the renewal into the registration expiration date, which is often connected to the approval date at

\(^{56}\) § 436.9(c)

\(^{57}\) § 436.9(c)(1)

\(^{58}\) § 436.9(c)(2)


\(^{60}\) § 436.7(a); See Statement of Basis and Purpose, § III.E.1, 72 Fed. Reg. at 15518.

\(^{61}\) California (§ 31121); Bus. Franchise Guide (CCH) § 3050.40.

\(^{62}\) Hawaii (§ 482E-3(d)); Bus. Franchise Guide (CCH) ¶ 3110.03.

\(^{63}\) Minnesota (§ 80C.08); New York (Regs. § 200.8); Rhode Island (§ 19-28.1-9(d)); South Dakota (§ 37-5A-41);
Bus. Franchise Guide (CCH) ¶¶ 3230.08; 5320.08; 3390.09; 3418.14, respectively.
some time during the year.\textsuperscript{64} In addition, Illinois requires the information to be current within 120 days of the filing.\textsuperscript{65}

The timing of updates in 2008 may largely be unaffected by the FTC’s amended annual updating requirements, unless the states act to conform their annual renewal requirements before then.

I. Material Amendments (§ 436.7(b))

The Amended FTC Franchise Rule requires material amendments to be made within a reasonable time after the close of each quarter of the fiscal year.\textsuperscript{66} The annual update can include the first quarterly update. The material amendments can be incorporated into the disclosure document itself or as an addendum.\textsuperscript{67}

Many of the states require that material amendments be made promptly after the event occurs, although Illinois law requires updates to be made within 90 days, Minnesota, South Dakota and Wisconsin say within 30 days, and other states say promptly, upon occurrence or as soon as reasonably possible.\textsuperscript{68} With the exception of Illinois and a few other states, many states may require material amendments to be incorporated into the disclosure document itself.

With regard to amendments, franchisors must keep in mind that although it may not file its amended disclosure document for 30 to 90 days, the disclosure document is materially deficient until it is revised, submitted to and approved by the applicable registration states. That being the case, continued use of a disclosure document that omits material facts exposes the franchisor to various forms of liability for possible illegal sales activities. In such situations, it would be prudent for the franchisor to delay its closing of franchise sales under the existing disclosure document, redisclose with the amended disclosure document when it has been filed or approved, and then wait the appropriate delivery period.

At this time, the industry does not know whether the states will act to conform their material amendment updating requirements to the Amended FTC Franchise Rule time period, but some uniformity in this regard would likely be welcomed by the industry.

\textsuperscript{64} Illinois (§ 705/10 and Regs § 200.603(a)); Indiana (§ 18); Maryland (§ 14-219 and Regs. 07.A), Michigan (§ 445.1507a); North Dakota (§ 51-19-07(4)(b)); Virginia (Regs. 5-110-50); Washington (§ 19.100.070(1)); Wisconsin (§ 553.26(3)); Bus. Franchise Guide (CCH) ¶¶ 3130.10; 5130.45; 3140.18; 3200.19; 5200.07; 3220.07a; 3340.07; 3470.07, respectively.
\textsuperscript{65} Illinois (Regs. § 200.603(a)(2)); Bus. Franchise Guide (CCH) § 5130.45.
\textsuperscript{66} § 436.7(b).
\textsuperscript{67} Statement of Basis and Purpose, § III.E.2, 72 Fed. Reg. at 15518-15519.
\textsuperscript{68} California (§ 31123); Hawaii (§ 482 E-3(b)); Illinois (§ 705/11); Maryland (§ 14.220(a) and Reg. §06A(1)); Michigan (§ 445.1519); Minnesota (§ 80C.07); New York (§ 683.9(a)); North Dakota (§ 51-19-07.6.a); Rhode Island (§ 19.28.1-11); South Dakota (§ 37-5A-40); Virginia (Regs. § 5-110-40); Washington (§ 19.100.070); Wisconsin (§ 553.31(1)); Bus. Franchise Guide (CCH) ¶¶ 3050.42; 3130.11; 3200.20; 3220.19; 3230.07; 3230.04; 3340.07; 3390.11; 3410.40; 5460.04; 3470.07; 3490.13, respectively. Indiana does not require filing of a material amendment.
J. Disclosure While Annual Updating or Material Amendment Is Being Prepared (§ 436.7)

In its FAQs, the FTC addressed the question of how a franchisor should handle a request from a prospective franchisee who asks for a copy of the disclosure document at a time when the franchisor is preparing its annual update or is awaiting renewal in one or more of the registration states. The FTC said that if a request for disclosure comes at a time when the franchisor is not obliged to have finished updating its disclosures, the franchisor can provide the then-current version of the disclosures, even if they will change with the next update.

For example, if the franchisor is in the middle of its fiscal quarter or is in the middle of the 120-day period after the close of its fiscal year for preparing an annual update, it may continue to provide prospects with its most current document. In order to avoid any possible misrepresentations, however, the ‘best practices’ would be for the franchisor to inform the prospect that it is preparing revised disclosures and to make such revised disclosures available to the prospective franchisee when issued or registered. At the very least, however, the franchisor must provide copies of its updates to a prospect, upon reasonable request, before the prospect signs the franchise agreement.69

The FTC emphasized that the Amended FTC Franchise Rule does not require a franchisor to update its disclosures continuously or immediately upon every new occurrence, or to stop selling until it has updated its disclosures. Because prospects who receive a disclosure document early in the sales process may not have the benefit of the most current information when they sign their franchise agreement, the FTC “included § 436.9(f) in the amended Rule, which forbids a franchisor from failing to furnish a copy of its most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisee signs a franchise agreement.”70

K. Sophisticated Investor Exemptions (§ 436.8)

There are three new “sophisticated investor” exemptions.71 The first new exemption is for “large investments.”72 The key threshold here is that the franchisee must make an initial investment of $1 million or more -- excluding franchisor financing or the cost of unimproved land -- within the first 3 months of operations.

For a transaction to qualify as a “large investment,” at least one individual investor (that is, at least one owner of the franchisee) must invest at this threshold level.73 A transaction is not exempt if 10 shareholders of a franchisee each invest $100,000. Franchisor financing is excluded because the FTC does not want franchisors raising the initial investment just to qualify for the exemption and lending the franchisee the extra funds to get over the threshold.

To figure out if a franchise program qualifies for the large investment exemption, the franchisor can aggregate all of the expenses that it estimates the franchisee will pay during the Item 7 time frame. For example, if -- during the time from when the parties sign a franchise

69 FAQs, Question 14.
70 Id.
71 § 436.8. See footnote 25.
72 § 436.8(a)(5)(i).
73 Id. at note 11. See FAQs, Question 3.
agreement to the point when the franchisee has been operating the franchise business -- the franchisee also buys area development rights and pays the franchisor an area development fee of, for example, $20,000 for 5 locations or $100,000, the franchisor can add the $100,000 to the franchisee’s initial investment to determine if the overall transaction exceeds the $1 million threshold. In other words, a franchisor may aggregate all expenses that it estimates will be paid by the franchisee during the Item 7 initial period, even for additional franchises for the same system.

To claim the “large investment” exemption, the franchisee must sign an acknowledgement that the franchise sale is exempt from the Amended FTC Franchise Rule because the franchisee will be making an initial investment of at least $1 million. The execution of the acknowledgement will serve several purposes. First and foremost, the franchisee will be in full agreement with the franchisor regarding the investment amount. Second, the franchisee’s admission that its franchise purchase is exempt from the Amended FTC Franchise Rule will likely preclude allegations of fraud and/or enforcement actions down the road. Third, the specific cite to the Amended FTC Franchise Rule will prompt the prospect to do its own due diligence under the Rule.

Only sales above the $1 million threshold in non-registration states are excused from federal disclosure. If some of a franchisor’s sales involve an initial investment above the $1 million threshold, while others fall below the $1 million threshold, the franchisor will still need to convert its disclosure document to the Amended FTC Franchise Rule format in order to sell at levels below the threshold.

The second exemption is for “large franchisees.” These are sales to franchisee entities that have at least 5 years of business experience in any line of business and a $5 million net worth. Note that the exemption only applies to franchisees that are business entities, not to high net worth individuals.

The third new exemption is for “franchisor insiders” — officers, directors, general partners, or individuals with management responsibility — that meet certain ownership tests. Many franchisors believe that insiders are exempt already under the law, but that is not true. The original FTC Rule never had an exemption for insiders, and while a few states have such an exemption, only California’s is as broad as that in the Amended FTC Franchise Rule. Now, at least in non-registrations states, a franchisor will be able to make sales to insiders without having to provide a franchise disclosure document. Caution: a franchisor cannot claim these exemptions until it converts its disclosure format to the Amended FTC Franchise Rule format.

Even though a transaction is exempt, a franchisor that sells in both registration and non-registration states should consider providing the exempt prospect a disclosure document. The franchisor will have to prepare and maintain a disclosure document in compliance with state registration requirements any way, so why not disclose these franchise prospects? Providing an exempt prospect with a copy of a disclosure document will not “undo” any of the three exemptions. The transaction will remain exempt.

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74 § 436.8(a)(5)(ii); Statement of Basis and Purpose, § III.F.3.b, 72 Fed. Reg. at 15527-15528.
75 § 436.8(a)(b); Statement of Basis and Purpose, § III.F.3.c, 72 Fed. Reg. at 15528-15529.
76 California (§ 31106(a)); Bus. Franchise Guide (CCH) § 3050.282.
The argument for providing a disclosure document is that disclosure documents do serve useful functions. They impart information about the benefits (and perhaps pitfalls) of the franchise program and aid the franchisor in establishing realistic expectations regarding the franchise opportunity. Also, a disclosure document can be a good defensive tool for identifying the actual information a franchisee received before buying the franchise. Note: if the franchisor does voluntarily provide a disclosure document to exempt prospects, the 14 calendar-day delivery rule would not apply.

L. Parent Disclosure (Amended Items 1, 3, 4 and 21)

Of all of the changes in the Amended FTC Franchise Rule, the ones which are the most problematic and that present the most challenges for franchisors are the expanded parent disclosure obligations. The existing UFOC Guidelines do not specifically require parent disclosures, although, as a practical matter, most franchisors probably already disclose the parent in Item 1 of the Offering Circular in some fashion. The Amended FTC Franchise Rule will now require parent disclosure in four different Items of the Franchise Disclosure Document.

“Parent” is defined as “an entity that controls another entity directly, or indirectly through one or more subsidiaries.” The focus is on control, not ownership. In its FAQs, the FTC stated that a parent that merely owns, but does not control, a franchise system (e.g., 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.

A franchisor will have parent disclosure obligations in Amended Items 1, 3, 4 and 21. Most of these new disclosure obligations will be relatively straightforward, but the obligations in Amended Item 21 could affect how some franchisors are structured.

In Amended Item 1, a franchisor will simply have to disclose the name and principal business address of any “parents.” Note the use of the plural. In its FAQs, the FTC addressed whether the term “parent” in Item 1 is intended to be interpreted narrowly to cover only the “ultimate parent that controls all the subsidiaries.” The FTC added that the use of the word “parents” is intentional, anticipating that a franchisor may be required to disclose one or more parents, provided that such parents control the franchisor. But the franchisor must disclose only those parents that in fact exercise control over the policies and direction of the franchise system. “For many franchise systems, this may mean the ‘ultimate parent,’ but such determinations can be made only on a case-by-case basis depending upon the particular facts.” Most franchisors probably make this type of disclosure now anyway.

In Amended Item 3, Litigation, a franchisor will need to disclose pending and concluded litigation with respect to a “parent” (note the singular) who either “induces franchise sales by promising to back the franchisor financially or otherwise guarantees the franchisor’s
The FTC did not explain its intent of a parent inducing “franchise sales by promising to back the franchisor financially”. It may be another way of referring to franchisors who have post-sale performance obligations. In its FAQs, the FTC explained that:

“Financial backing” here is intended to refer to promises that a parent may make to ensure that the franchise system is and remains on stable financial footing. Typically, this would mean that the parent 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.

This section of Amended Item 3 is a considerable expansion of the franchisor's disclosure obligation insofar as parent litigation is concerned. Interestingly, however, for currently effective injunctive or restrictive orders issued by a public agency, the Amended Item 3 disclosure is limited to a parent who guarantees a franchisor's performance, which will provide franchisors with some recordkeeping relief.

In Amended Item 4, the bankruptcy of “any parent” would have to be disclosed. The FTC claims that the reason for this disclosure is that when the parent is in bankruptcy, its assets will include any franchisor subsidiary. This is valid reasoning and it is hard to argue with this rationale. In its FAQs, the FTC said the disclosure of parent information in Item 4 is intended to be consistent with that of Item 1. “If any of the parents listed in Item 1 have had a bankruptcy in the relevant time period, then that information must be disclosed in Item 4.”

The parent disclosure change that could affect the way some franchisors do business is the new parent disclosure required in Amended Item 21. UFOC Item 21 now requires the franchisor to incorporate its audited financial statements the UFOC, but it can use the financial statements of a parent or affiliate as long as the parent or affiliate guarantees the franchisor’s duties and obligations under the franchise agreement. However, Amended Item 21 will also require inclusion of the financial statements of the franchisor and “any parent” that “commits to perform post-sale obligations for the franchisor or guarantees the franchisor’s obligations.” The FTC said that in such situations, the financial stability of the parent becomes a material fact that should be disclosed.

In one of its early FAQ’s, the FTC said that if a parent happens to supply goods and services to franchisees where there is no underlying obligation on the part of the franchisor to supply them, then the parent is no different than any other third party supplier and its financials

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83 § 436.5(c)(1).
85 FAQs, Question 16.
86 § 436.5(c)(2).
87 § 436.5(d)(1).
89 FAQs, Question 16.
90 § 436.5(u).
need not be disclosed. However, if the franchisor is obligated to provide goods and services and the parent resumes that responsibility, then the parent’s financials must be disclosed.\textsuperscript{92}

This new financial disclosure requirement may especially hit hard on private companies and foreign franchisors. Historically, many private companies and many foreign franchisors have set up wholly owned subsidiaries to engage in franchise activities for a variety of legitimate business reasons, and often the parent or an affiliate provides services of some sort or another for the benefit of the franchisor or for the franchisees in the system.

In a subsequently issued FAQ, the FTC helpfully clarified that “the disclosure of parent financial information is required only when the franchisor’s parent commits to perform post-sale obligations for the direct benefit of franchisees. Agreements between a franchisor and its parent for administrative and other services for the franchisor’s internal purposes do not trigger the parent financial disclosure requirement.”\textsuperscript{93}

With respect to whether the parent disclosure is triggered by any commitment to perform post-sale services, or whether a substantial commitment is required, the FTC further clarified by stating that:

\begin{quote}
[T]he amended Rule requires parent financial statements where the parent commits to perform or guarantees the franchisor’s obligations. FTC staff believes that the use of the plural ‘obligations’ was intended to convey that the performance of a single or isolated obligation alone is insufficient to trigger the parent financials disclosure. At the same time, Item 21 sets forth no specific threshold standard, such as ‘substantial obligations,’ or ‘preponderance of obligations.’ Accordingly, FTC staff would expect a parent to disclose its financials if it commits or guarantees to perform more than an isolated obligation to franchisees on behalf of the franchisor.\textsuperscript{94}
\end{quote}

Franchisors that now rely on a parent to provide post-sale services to its franchisees will have a relatively short time to review their current structure and determine the best way to deal with this issue if they want to avoid attaching the parent’s financials. The issue will be: is it necessary to restructure the franchise operations to avoid and minimize these new parent disclosure requirements?\textsuperscript{95}

By “restructuring,” it may be possible for a franchisor to use an affiliate, rather than the parent, to provide post-sale services. Amended Item 21 does not specifically apply to an affiliate — only a parent. In its FAQs, the FTC confirmed an affiliate need not disclose financials unless it qualifies as a “parent” and commits to perform or guarantees the franchisor’s post-sale obligations.\textsuperscript{96}

A related issue is whether the disclosure of the parent financials would be triggered if a parent’s employees perform services on behalf of a franchisor. The FTC noted that this would akin to providing back office support for the franchisor. The FTC said in its FAQs:

\begin{quote}
\end{quote}

\begin{itemize}
\item \textsuperscript{92} FAQs, Question 4.
\item \textsuperscript{93} FAQs, Question 16.
\item \textsuperscript{94} \textit{Id.}
\item \textsuperscript{95} \textit{Id.}
\item \textsuperscript{96} FAQs, Question 16, note 5.
\end{itemize}
In the opinion of FTC staff, the Item 21 parent financials disclosure is intended to cover formal arrangements between the parent and franchisor for the benefit of franchisees or formal arrangements directly between the parent and franchisees. The performance of post-sale obligations by a parent’s employee for the benefit of franchisees does not trigger the Item 21 parent financial disclosures, absent a formal commitment or guarantee on the part of the parent to perform. 97

If the parent’s financials have to be attached to the disclosure document because the parent is providing services to franchisees, there may be no reason to prepare separate audited financial statements for the franchisor-subsidiary unless the parent does not want to guarantee its franchisor subsidiary’s obligations.

M. Revised Item 20 Charts (Amended Item 20)

The FTC completely revamped the Item 20 tables. 98 Many practitioners may believe that the changes to Amended Item 20 will probably be the most time consuming part of the conversion process for franchisors with a significant number of franchisees.

Instead of 3 tables, there are now 5 tables. The tables have been reworked to eliminate the potential for double-counting, which is a flaw in the UFOC’s current system. 99 As a franchisor must do now, Amended Item 20 will cover the franchisor’s last 3 fiscal years. Because of the new style of formatting, however, the number of pages devoted to the Item 20 charts will likely double. The 5 new tables will cover the following:

Table 1 is a system-wide summary showing the number of company-owned and franchised outlets opened at the start of the fiscal year, new openings and closures during the year, and the number still open at the end of the fiscal year.

Table 2 shows franchisee-to-franchisee transfers during each of your last three fiscal years. This table will exclude outlets that a franchisor buys back. A franchisor will no longer be able to include a separate column for transfers in the system-wide summary chart.

Table 3 will show the turnover rate for individual franchise outlets, organized by state, for each of the franchisor’s last three fiscal years. Here, the chart will show terminations, non-renewals and re-acquisitions by state, reporting the last in time event. If the same outlet ceases to do business and then was later terminated, you would report that outlet as a termination.

Table 4 tracks the turnover at company-owned units. Here, the chart will show, for each of the franchisor’s last three fiscal years, the number of company-owned outlets at the start of the year, new outlets opened, outlets reacquired from a franchisee, closed outlets, outlets sold to franchisees, and the number of company-owned outlets still owned by the franchisor on the last day of its fiscal year.

Table 5 retains the current UFOC projected openings table.

97 FAQs, Question 16, note 6.
98 § 436.5(t).
Table 4 addresses company-owned outlets. It is not clear if franchisors are supposed to include affiliate-owned outlets in Table 4, but it appears that the FTC intends for franchisors to count affiliate-owned outlets as company-owned. Hopefully, the FTC will further clarify that point. For the time being, if the franchisor’s financial statements consolidate the financials of a subsidiary or joint venture operating a franchised location, a franchisor may wish to treat that unit as being company-owned.

**N. Previously Owned Outlets (Amended Item 20)**

If a franchisor buys back a franchise outlet from a franchisee and resells it, Amended Item 20 now requires the franchisor to disclose, by way of an addendum, just to the prospective franchisee considering buying the outlet, the name of each previous owner of that outlet for the last five years. This is a big change from the current UFOC, and is designed to reveal churning by the franchisor or a problem location.

**O. Franchisee Advisory Councils and Trade Association (Amended Item 20)**

Franchisors must now include in Amended Item 20 contact information for each trademark-specific franchisee advisory council or franchisee association that they create or endorse, whether the franchisor handpicks the members or they are elected by franchisees.

Additionally, a franchisor must also disclose contact information for any trademark-specific franchisee association organized under state law that includes its franchisees as members and asks to be included in the disclosure document within 60 days after the end of the franchisor’s fiscal year. The independent associations must be incorporated or otherwise organized under state law; this is a modest standard added to prevent any disgruntled individual franchisee or group of franchisees from getting themselves listed. The franchisee association must be specific to the brand -- so, for example, the American Association of Franchisees & Dealers, whose members come from numerous franchise systems, cannot get itself listed in any specific converted disclosure document. Any such independent association must renew its request for inclusion on an annual basis, and franchisees need not update this disclosure quarterly. A one-time annual update is all that is required.

**P. Confidentiality Clauses (Amended Item 20)**

One of the new disclosure requirements in Amended Item 20 is a disclosure as to whether any franchisees have signed confidentiality (or “gag”) clauses during the franchisor’s last three fiscal years that restrict a current or former franchisee from discussing his or her personal experiences as a franchisee in the franchisor’s system with any prospective franchisee. However, the new disclosure does not include clauses that protect the franchisor’s trademarks or other proprietary information.

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100 § 436.5(t)(6).
102 § 436.5 (t)(8)(i).
103 § 436.5(t)(8)(ii).
105 § 436.5(t)(7).
Q. **Integration Clauses (§ 436.9(h))**

The Amended FTC Franchise Rule says that it is an unfair or deceptive act or practice for any franchise seller to disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or its exhibits or amendments. This does not prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sales negotiations. Does this mean that a franchisor cannot use an integration (or entire agreement) clause in its franchise agreement?

This provision generated a lot of comment during the rule-making process. The FTC explained that the purpose of this provision is to prevent fraud by preserving the completeness and accuracy of information contained in disclosure documents. It is a limited disclaimer prohibition. The FTC stated that it is “convinced” that integration clauses have valid purposes, “including ensuring that a prospective franchisee relies solely on information authorized by the franchisor or within the franchisor’s control in making an investment decision.” At the very least, those clauses protect a franchisor from unauthorized statements or representations made by non-agent third parties.

The FTC believes that franchise sellers should not be able to use integration clauses or waivers to insulate themselves from false or deceptive statements made in a franchisor’s disclosure document. The FTC felt that this was particularly true with respect to matters other than the terms of the franchise agreement, such as franchisor’s prior business experience, litigation history, financial performance representations and financial statements.

The FTC clarified that this provision does not reach statements made in a franchisor’s advertising materials. Also, the provision does not prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in the disclosure document during the course of franchise sales negotiations. Franchise sellers and prospective franchisees remain free to negotiate the terms of the franchise agreement.

Some franchisors use franchise disclosure questionnaires and similar documents that require a franchisee to certify before closing that there were no extraneous representations made to them outside the terms of the franchise agreement. Those documents would appear to be outside the scope of this provision because they are part of the negotiation process.

Franchisors should review the integration clauses in their franchise agreements to make certain that they do not violate this prohibition. Most integration clauses simply say all prior negotiations are merged into the written agreement and do not specifically reference the matters in the disclosure document. The FTC staff is expected to clarify this issue in its upcoming Guidelines, and most likely will offer a sample integration clause that it would find acceptable. One example of an integration clause that was submitted to the FTC during the rule-making process, and the bold portion of which seems to comply with the FTC’s anti-waiver language, is as follows:

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107 § 436.9(h).
109 Id. at 15534.
1.01 Integration of Agreement

This Agreement, all exhibits to this Agreement and all ancillary agreements executed contemporaneously with this Agreement constitute the entire agreement between the parties with reference to the subject matter of this Agreement and supersede any and all prior negotiations, understandings, representations and agreements; provided, however, that nothing in this or any related agreement is intended to disclaim the representations we made in the franchise disclosure document that we furnished to you. You acknowledge that you are entering into this Agreement, and all ancillary agreements executed contemporaneously with this Agreement, as a result of your own independent investigation of the franchised Business and not as a result of any representations about us made by our shareholders, officers, directors, employees, agents, representatives, independent contractors or franchisees which are contrary to the terms set forth in this Agreement or of any offering circular, prospectus, disclosure document or other similar document required or permitted to be given to you pursuant to applicable law.110 (Emphasis supplied.)

R. Franchise Sellers and the Receipt Pages (Amended Item 23)

“Franchise seller” information must go on the Receipt pages of the Franchise Disclosure Document.111 The Amended FTC Franchise Rule defines the “franchise seller” as any “person that offers for sale, sells or arranges for the sale of a franchise”, and specifically includes the franchisor and its employees, representatives, agents, subfranchisors and third party franchise brokers who are involved in franchise sales activities.112 In its FAQs, the FTC clarified that when a franchisor pays an existing franchisee a referral fee for referring leads to the franchisor, that is not enough to bring them within the definition of “franchise seller.” However, the definition does include brokers.113

An issue that arises is whether the specific name of the actual individual seller has to go on the Receipt pages. If that is the case, most likely a blank line would have to be added to the Receipt pages so that the actual franchise seller could insert his or her name into the disclosure document before providing it to a prospective franchisee. That seems to be impractical and unworkable.

In its FAQs, the FTC defined who a franchise seller is for purposes of Amended Item 23. The FTC said the Receipt Pages should identify and provide contact information for persons who have significant contacts with the prospective franchisee. In particular, the FTC identified individuals who assist prospective franchisees in completing applications and other forms, or who engage in ongoing conversations throughout the sales process. Any person who receives a sales commission and/or quota credit if a deal is consummated must be listed on the Receipt Pages. However, the Receipt Pages do not replicate Amended Item 2. The FTC said:

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110 Reprinted with permission of David J. Kaufmann, Kaufmann, Feiner, Yamin, Gilden & Robbins LLP, New York, NY.
111 § 436.5(w)(2).
112 § 436.1(j); Statement of Basis and Purpose, § III.A.10, 72 Fed. Reg. at 15460-15462.
113 FAQs, Question 7.
Franchisors should not include a generalized list of all subfranchisors, brokers, or other individuals that may be involved in the sales process, but who do not have contacts with the individual prospective franchisee who will sign the receipt page.114

Anticipating a reaction that this would require an individualized disclosure document for each prospective franchisee, the FTC offered this guidance:

A franchisor need not create an individualized disclosure document for each franchise sale. It is the FTC staff’s view that if, at the time of furnishing the disclosure document, a franchisor does not know the particular seller, such as a broker, the franchisor has several options. First, a franchisor could include an instruction in the receipt page that the prospective franchisee write in the name of the franchise seller before signing and returning the receipt page to the franchisor. Second, the franchisor could: (1) attach to the previously signed receipt a statement, business card, or other document showing the name of the seller; and (2) send a copy of the attachment to the prospective franchisee so that the prospective franchisee has a copy of the completed receipt. At that point, both the franchisor and prospective franchisee will each have a copy of the same receipt. In short, in the FTC staff’s view, the absence of an identifiable seller at the time of disclosure should not force a delay in the prospective franchisee’s ability to sign the receipt page, provided that the receipt page is updated once the identity of the seller is known.115

S. Recordkeeping Rules (§ 436.6(h))

For the first time, the FTC is imposing record-keeping duties on franchisors. The Amended FTC Franchise Rule will require a franchisor to keep each materially different version of its disclosure document and a copy of each signed receipt for three years after the end of the fiscal year in which the franchisor used the disclosure document or makes the sale.116 The original FTC Franchise Rule had no record-keeping duty.

Franchisors should be aware that most of the registration states have had record-keeping requirements on their books for a long time,117 so the FTC’s new recordkeeping standards should not significantly increase a franchise company’s compliance burdens. What is significant about the Amended FTC Franchise Rule change is the time period for which records should be kept. None of the states have time periods in their statutes or regulations, except for Hawaii (6 years from the closing of any franchise account) and Rhode Island (5 years). Also, the franchisor’s home jurisdiction may have generally applicable record-keeping requirements with which franchisors will also need to comply. For example, in Illinois, business records must

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114 FAQs, Question 12.
115 Id.
116 § 436.6(h); See Statement of Basis and Purpose, § III.D.8, 72 Fed. Reg. at 15517-15518.
117 California (§ 31150); Hawaii (§ 482E-5, Regs. 16-37-7); Illinois (§ 705/36), Indiana (§ 21); Maryland (§ 14-224, Regs. 02.02.08.15); Michigan (§ 445.1520); Minnesota (§ 80C.10); New York (§ 683.14(a)); North Dakota (§ 51-19-16); Oregon (§ 650.010); Rhode Island (§ 19.28.1-13); South Dakota (§ 37-5A-52); Washington (§ 19.100.150); Bus. Franchise Guide (CCH) ¶¶ 3050.45; 3110.05; 5110.07; 3130.36; 3140.21; (continued) (Continued) 3200.24; 5200.15; 3220.20; 3230.10; 3320.04; 3340.16; 3370.02; 3390.13; 3410.52; 3470.15, respectively. None exists in Virginia or Wisconsin.
be maintained for at least three years. There may also be other recordkeeping requirements that may apply to specific aspects of a franchisor's business.

As a practical matter, a franchisor should maintain a complete file on each active franchisee for the entire period of that relationship, and for a reasonable period afterwards, perhaps one tied to the franchisor's home jurisdiction's contractual statute of limitations period. The Hawaii regulation seems to take that approach. In addition, it would be prudent for franchisors to maintain a complete, historical set of disclosure documents used in the business. If maintaining paper copies is a problem, then store the records on CD-Roms or other electronic media.

In its FAQs, the FTC said that it expects that copies of the signed Receipt Pages to be maintained for at least three years will include the required contact information for sellers, either because the contact information was filled in before the franchisor furnished disclosures to the prospect, or was attached to the Receipt Pages once such contact information was known after the prospective franchisee signed the Receipt Pages.119

T. Inconsistent or Additional Disclosures (§ 436.6(d))

Although the Amended FTC Franchise Rule requires franchisors to respond fully to each disclosure item120, and “disclose” means to present all material facts accurately, clearly, concisely and legibly in plain English,121 the FTC prohibits franchisors from including in their disclosure documents any materials or information other than those required by Part 436 or by state law not preempted by Part 436.122 This has two practical implications.

First, where the Amended FTC Franchise Rule has mandatory language that must be used in a particular disclosure Item, such as the boilerplate provisions in Amended Item 19, those statements must be used verbatim and the franchisor is prohibited from improvising or inserting language in an attempt to limit its liability.

Second, and still unclear, is how much additional information can be added to the disclosure document to provide other information the franchisor believes material to a particular disclosure item. The FTC does not want franchisors including information that is non-material, confusing or distracting from the core disclosure.123 However, the FTC recognizes that it may be desirable to include additional material information in a disclosure document to ensure that the required disclosures are accurate. The FTC said the prohibition on adding to a disclosure document should be read narrowly to prohibit the inclusion of materials that are not specifically required or permitted by the Amended FTC Franchise Rule. The franchisor can add brief footnotes or other clarifications to ensure that disclosure is complete and not misleading. The franchisor also can include information that is required by state law.

119 FAQs, Question 12.
120 § 436.6(c)
121 § 436.1(d)
122 § 436.6(d).
The FTC also observed that nothing in the Amended FTC Franchise Rule prohibits a franchisor from furnishing prospective franchisees with non-deceptive and non-contradictory information outside of the disclosure document.¹²⁴

U. Development Agents (§ 436.1(k))

Many franchisors use independent third parties to solicit prospects and/or perform post-sale services for franchisees. These parties go by various names: development agents, area developers, area representatives, master franchisees, etc. (collectively, “Development Agents”). Are these types of agents subfranchisors for purposes of the Amended FTC Franchise Rule? A subfranchisor is someone who “functions as a franchisor by granting a franchise and participating in the sales relationship.”¹²⁵ Simply providing post-sale services does not make the Development Agent a subfranchisor under the Amended FTC Franchise Rule unless that person is a party to the franchise or other agreement with the franchisee. The Development Agreement must have the authority to enter into a franchise agreement and be obligated to perform after the purchase is consummated to be covered by the Amended FTC Franchise Rule.¹²⁶

Development Agents typically have contractual obligations with the franchisor to provide post-sale assistance to the franchisees for which they receive compensation or a commission payment from the franchisor. Because they have no post-sale commitments directly to the franchisees, they are not a subfranchisor for Amended FTC Franchise Rule purposes.

There are two states where Development Agents might be considered a subfranchisor because of the unique definitions in their state statutes: California¹²⁷ and Illinois.¹²⁸ Reportedly, California may amend its law to bring it into conformity with the FTC position, but there has been no word as to whether Illinois will follow suit.

V. Franchise Relationship Charts (Amended Item 17)

Amended Item 17 requires the franchisor to disclose certain relationship matters in franchise or related agreements in chart form.¹²⁹ Can more than one chart be used? In its FAQs, the FTC clarified that a franchisor can always use separate charts for different agreements, whether those are in Amended Item 17, Amended Item 20 or other disclosure items. “The use of separate charts for different agreements fosters precision and clarity, consistent with the goal of full and accurate disclosure.”¹³⁰

V. STATE RESPONSES TO AMENDED FTC FRANCHISE RULE

As noted above, the FTC did not preempt existing state registration and disclosure requirements. That means that while the Amended FTC Franchise Rule will be the national standard, the states remain free to impose additional requirements as long as those

¹²⁴ Id. at note 733, citing former 16 C.F.R. § 436.1(a)(21).
¹²⁵ § 436.1(k).
¹²⁶ FAQs, Question 9.
¹²⁷ California (§ 31008.5); Bus. Franchise Guide (CCH) ¶ 3050.105.
¹²⁸ Illinois (§ 3(4)); Bus. Franchise Guide (CCH) ¶ 3130.03.
¹²⁹ § 436.5(q).
¹³⁰ FAQs, Question 13.
requirements do not conflict with the Amended FTC Franchise Rule while providing greater protection to franchise prospects.

NASAA stated in its Statement of Policy adopted June 22, 2007\textsuperscript{131} that all of the registration states will accept an Amended FTC Franchise Rule disclosure document as of July 1, 2007 even though their statutes and regulations still refer to disclosure documents prepared under the UFOC Guidelines.

Sections III and IV of this paper have addressed the key changes to the disclosure document under the Amended FTC Franchise Rule with their corresponding impact on industry and, of course, the manner in which state franchise examiners will need to alter processing procedures. Since those sections have aptly addressed the key points, this Section V will focus on significant issues from a state franchise examiner’s perspective and in the expectation that the final NASAA document will be similar to the Amended FTC Franchise Rule.

A. **NASAA Interim Statement of Policy**

Under the June 22, 2007 NASAA Statement of Policy, states will accept franchise disclosure documents prepared under the Amended FTC Franchise Rule, with certain additional requirements, including a somewhat familiar additional (or supplemental) state risk factor cover page, even though their statutes or regulations may refer to disclosure documents prepared under the UFOC Guidelines. While the states are generally sympathetic to the concept of uniformity, they are not going to give up their registration review rights and most of them are not likely to give up their own unique disclosure requirements.

The primary purpose of both state and federal franchise laws is to ensure that franchise prospects have access to and receive the material information regarding a franchise system which will enable them to make a reasoned determination as to whether or not to enter into a franchise relationship with a specific franchisor. That said, it remains essential that the disclosure document presented to prospective franchisees be “uniform” as well as complete so that prospects are capable of making such a decision. The states maintain review rights to ensure that the disclosure requirements are complied with.

A disturbing trend that Illinois has experienced recently is that of the original filings thus far this year, at least 60% have initially been denied due to the lack of proper financial statements and/or the imposition of financial assurance requirements. When the actual original applications are processed and the disclosure documents examined, at least 30% of the filings result in the cessation of review within the first 10 Items due to the number of deficiency comments.

It is Illinois’ experience that the deterioration in disclosure document compliance encompasses the work product of experienced practitioners as well as those new to the franchising arena. If practitioners have yet to master the nuances of the UFOC Guidelines by disclosing required, invaluable facts and figures, the need to maintain reviews increases considerably under the new disclosure format.

\textsuperscript{131} See Section II of this paper for a citation.
(1) **Uniform Franchise Disclosure Document**

NASAA is currently reviewing its Uniform Franchise Offering Circular Guidelines to determine how they should be amended to reflect the Amended FTC Franchise Rule revisions. Among other things, NASAA is revising its application package and instructions for filing.

(2) **State Cover Page and Effective Date Exhibit**

As previously mentioned, the “new” state cover page is similar to the “old” UFOC cover page, specifically, with references to the various state franchise laws as well as risk factors. However, franchisors should note a few important changes, including references to renewal rights as well as the franchisor’s use of franchise brokers for those franchisors using brokers. Additionally, the exhibit with the various state effective dates is to be placed immediately after the state cover page, thereby providing for the first time uniformity as to the location where the various states effective dates can be found.

(3) **Business Experience (Amended Item 2)**

As to franchise brokers, it appears that at least some of the registration states believe that broker disclosure is valuable to prospective franchisees even though the Amended FTC Franchise Rule removed the prior UFOC Item 2 broker disclosure requirements. However, this certainly is not the final word on franchise broker disclosure or registration. The end result remains to be seen as the states go through the amendment and adoption processes.

(4) **Litigation (Amended Item 3)**

The FTC’s materiality position regarding financial disclosure relative to the franchisor’s parent(s), affiliate(s) and/or guarantor(s) in Amended Item 21 has been integrated into Amended Item 3, ensuring consistency between those Items as well as policy. Material actions impacting any one of the noted entities, more often than not, will have a corollary effect on interrelated or interdependent companies, which justifies the corresponding amendments to Amended Item 3.

(5) **Financial Performance Representations (Amended Item 19)**

The extensive modifications found in Amended Item 19 will certainly create a new learning curve for both industry and state examiners. The overall changes are very progressive, allowing for a reduction in the gap between the UFOC Guidelines and the Amended FTC Franchise Rule while also satisfying a long standing need for clarifications to this often controversial subject. Hopefully, Amended Item 19, in concert with the future Guidelines adopted by NASAA, will spur the franchising industry into increasing “financial performance representations” in their disclosure documents.

The Statement of Basis and Purpose states that approximately 20% of franchisors make financial performance disclosures. This is a small figure compared to the number of overall franchisors and the amount of monies franchising generates globally. From an examiner’s perspective, this is surprising and somewhat of a paradox.

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The addition of prescribed preambles, elimination of cost and expense information from the definition of financial performance, acceptance of subset data and the omission of GAAP standards reflect important changes to this Item and have been addressed in Section IV.F. However, the franchise examiner’s focus will be the reasonable basis criterion with the accompanying written substantiation statement.

Franchise examiners will review Amended Item 19 financial performance representations with an eye to ensuring that the requisite facts and figures required by Amended Item 19, paragraph (s)(3)(i)-(iv), are fulfilled. These provisions speak to (1) time periods for the financial performance representation; (2) use of the franchisor’s entire system or a subset as well as the subset’s particulars, i.e., geographic location, time in operation, franchises or company-owned units; (3) operating outlets during the relevant time period; and (4) percentages attaining/maintaining stated results, etc. If the financial performance representations do not sufficiently address the Amended Item 19 parameters for such a disclosure, the examiner can (and will) request the written substantiation data supporting such a disclosure.

A long-standing Item 19 issue is the use of “fill-in-the-blank” pro-formas; i.e., those documents that identify sales and expense categories with the corresponding figures to be determined by the prospect. This can be a daunting task for a prospect without any assistance, especially when the prospect is unfamiliar with a specific industry, franchise system or business in general. So who better to assist the prospect? The franchisor, of course. Suffice it to say that “fill-in-the-blank” pro-formas, which are unacceptable under the current UFOC Guidelines, will not be accepted as a financial performance representation under the Amended Item 19 format or the future NASAA Guidelines.

Franchisor use of affiliate and industry data will be an additional focus of the franchise examiner. Amended Item 19, clearly and unequivocally, states that all financial performance representations must have a “reasonable basis”. Does affiliate and industry data fall within those parameters?

The FAQs specifically addresses the use of affiliate information: “consistent with the UFOC Item 19, the amended Rule does allow franchisors to use affiliate information as a basis for a performance claim in certain narrow circumstances – specifically, when the franchisor lacks an adequate operating experience of its own. However as in the case of using any financial performance representation based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of such outlets that may differ materially from the outlets being offered for sale.”

Finally, industry data is unacceptable for Amended Item 19. This is also true under the current UFOC Guidelines.

(6) Integration Clauses (§ 436.9 (k))

The Amended FTC Franchise Rule prohibits the use of integration clauses or waivers disclaiming authorized statements by the franchisor. This FTC action has been fully embraced by all the registration states since it provides for a uniformity between federal and state law. This uniformity should reduce the workload for both franchise practitioners and examiners.

133 FAQs, Question 8.
because such disclaimers should be fully addressed by franchise practitioners prior to submission of franchise applications to the states. Integration clauses are discussed in detail in Section IV.Q of this paper.

(7) **Outlets and Franchisee Information (Amended Item 20)**

The extensive revisions to Amended Item 20 brings welcome clarity to the disclosure document. This Item will require franchise practitioners and franchise examiners alike to concentrate on its many new nuances, but once the content is mastered, the Item itself should not initiate any additional concerns for franchise examiners.

(8) **Financial Statements (Amended Item 21)**

Sections IV.A and IV.B of this paper thoroughly address the most salient revisions to Amended Item 21. The primary issue which will cause a divergence between state and federal law is the “phase-in-of-audit” and the FTC’s generosity regarding the acceptance of unaudited financials.

Illinois initiated a phase-in-of-audit protocol years ago, accepting unaudited financial statements for original registration applicants. However, Illinois expanded upon this requirement by citing the necessity for such financials to be prepared by an independent CPA in accordance with an accrual or GAAP method of preparation. Consequently, the adoption of the Amended Item 21 would require a reversal of the Illinois rule, which, for obvious reasons, appears unlikely.

South Dakota currently considers a phase-in-of-audit option on a case-by-case basis accepting unaudited financials from start-up companies on occasion. It is likely that South Dakota will adopt the FTC’s phase-in-of-audit position. The other states have not publicly indicated which direction they will travel when traversing through the amendment process.

(9) **Filing Under the NASAA Statement of Policy**


Dale Cantone, in his announcement of the issuance of the NASAA Statement of Policy to the Forum’s list serve on June 27, 2007, gave the following practical tips for filers:

For those franchisors who choose to file disclosure documents using the new FTC Rule format instead of the UFOC Guidelines, the NASAA Franchise Project Group has the following tips:

- In your cover letter accompanying your filing, clearly indicate the type of disclosure format you are using, either the new FTC Rule format or the UFOC Guidelines format.

- Do not mix and match formats.

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134 Illinois (Regs. §200.600.c)), Bus. Franchise Guide (CCH) ¶ 5130.42.
-Be sure to use the new state cover page prescribed under the NASAA Statement of Policy.


-Continue to file with each state franchise agency the same application forms required under the current UFOC Guidelines (and any state specific forms) and the same filing instructions.

-Continue to include with your disclosure document state specific provisions required under applicable state laws (by addenda if appropriate).

-If you file an amendment or renewal, do not forego a redlined copy showing changes from a previously filed document, but please check it for accuracy. (Examiners are reporting a surprising number of problems with redlined copies.)

-Be patient.\textsuperscript{135}

\textbf{(10) Existing State Statutes and Regulations}

The Amended FTC Franchise Rule was issued with such a short lead time for its effectiveness that it did not give the franchise registration and disclosure states sufficient time to amend their laws and regulations to conform to the Amended FTC Franchise Rule. Only one state (California) has acted so far. There are a variety of state provisions that may be in conflict with or inconsistent with the Amended FTC Franchise Rule and may need to be addressed by the states. These include:

\begin{itemize}
  \item[(1)] Some states require that financial statements be current within 90 or 120 days of the application date.\textsuperscript{136}
  \item[(2)] The state exemptions are different.\textsuperscript{137}
  \item[(3)] Three states have a first personal meeting rule in their statutes (Maryland, New York and Rhode Island).\textsuperscript{138}
  \item[(4)] Two states require that a disclosure document be given 10 business days before any contracts are signed or money paid (Michigan and
\end{itemize}

\textsuperscript{135} See Footnote 9 above.
\textsuperscript{136} See Footnote 51 above and accompanying text.
\textsuperscript{137} See Section III.I above.
\textsuperscript{138} Maryland (§ 14-223(1)); New York (§ 683.8); Rhode Island (§ 19-28.1-8(a)(1)); (Bus. Franchise Guide (CCH) ¶¶ 3200.23; 3320.04; 3390.08, respectively.
Washington). California had a similar provision, but the California statute was amended as of July 20, 2007 to provide for 14 days notice.

(5) Electronic disclosure is expressly permitted in two states, and only tacitly permitted in the other states.

(6) A number of states require state addenda (and Michigan still requires its addendum to follow the state cover page).

There is another legal concern. As outlined above, many of the states have statutory provisions or regulatory requirements that may be inconsistent with the requirements of the Amended FTC Franchise Rule. For example, as noted above, three franchise registration states have a statutory first personal meeting rule disclosure requirement in their statutes. That means that even if a franchisor were able to convert to the Amended FTC Franchise Rule format after July 1, 2007, and thus could take advantage of the Amended FTC Franchise Rule’s elimination of the first personal meeting disclosure rule, in those three states, the franchisor still would have to comply with the first personal meeting rule unless and until the state statute is changed.

There are a variety of other state law requirements that are inconsistent with the Amended Rule and may have to be modified. The unfortunate part is that most state legislatures only meet during the spring of each year, so in many states that means that statutory changes are not likely to be made until 2008, if then. With respect to regulatory provisions, while those theoretically can be made at any time, it could take anywhere from six to nine months to get a regulation revised.

While the FTC rejected preemption, there is some hope that the states will see a need for greater uniformity at the state level. It would help franchisors and franchisees alike to have one set of disclosure documents that can be used throughout the country. There currently may be more sympathy at the state level for uniformity than has been evident in the past, but that would mean that the states would have to reach consensus on items such as broker disclosure, the need for state specific addenda, the placement of those addenda, and a variety of other items where there currently is no uniformity.

(11) Further State Activity

As usual, California was the first state to take legislative action to conform its franchise law to the Amended FTC Franchise Rule. California Senate Bill 998 was passed by the California legislature and signed into law by the Governor on July 20, 2007. Section 31119 of

139 Michigan (§ 445.1508(1)); Washington (§ 19.100.080); Bus. Franchise Guide (CCH) ¶¶ 3220.08; 3478.08, respectively.
140 See Footnote 11 above.
141 See Footnote 9 above.
142 California (Bus. Franchise Guide (CCH) ¶ 5050.23); Hawaii (Bus. Franchise Guide (CCH) ¶¶ 4110.01 and 5110.04); Illinois (Bus. Franchise Guide ¶¶ 3130.04, 3130.19, 5130.50); Maryland (Bus. Franchise Guide (CCH) ¶¶ 3220.08, 5200.04, 5200.13); Michigan (Bus. Franchise Guide (CCH) ¶¶ 3220.08, 3220.27, 5220.01); Minnesota (Bus. Franchise Guide (CCH) ¶¶ 3230.14, 5230.31, 5230.61); New York (Bus. Franchise Guide (CCH) ¶ 5320.04); North Dakota (Bus. Franchise Guide (CCH) ¶ 3340.06); Rhode Island (Bus. Franchise Guide (CCH) ¶ 3390.14); Washington (Bus. Franchise Guide (CCH) ¶¶ 5470.78, 5470.76, 5470.78, 5470.85).
the Corporations Code was amended to provide that disclosure must be made at least 14 days prior to the execution of any binding or other agreement or receipt of any consideration, whichever occurs first. The amendment further provides that nothing shall prevent a franchisor from providing copies of offering circular documents through electronic means pursuant to any requirements or conditions that may be imposed by rule or order of the Commissioner. Section 31155 of the Corporations Code was amended to provide that a person who has filed a consent to service of process in connection with a previous registration need not file another.

Note: Illinois has been the lone state for the last 9 years with pre-sale disclosure requirements of 14 calendar days. Illinois amended its Franchise Disclosure Act in July 1998 to require 14 calendar-days disclosure and abolished the often confusing practice of counting business days.

VI. HOW THE FRANCHISE BUSINESS MODEL MAY BE AFFECTED

While the Amended FTC Franchise Rule has many positive attributes, its adoption may force some franchisors to review their franchise model to determine whether it should be modified in some respect. We will briefly highlight a few areas that may need to be addressed.

A. Disclosure Issues and Restructuring

As discussed in Section IV.L of this paper, the expanded parent disclosure obligations may require a franchisor to reexamine its business model. In this regard, Amended Items 3 and 21 may be of particular concern.

Amended Item 3 requires parent litigation to be disclosed if the parent either “induces franchise sales by promising to back the franchisor financially or otherwise guarantees the franchisor’s performance.” In FAQs, Question 16, the FTC said “financial backing” refers to “promises” made by a parent to infuse the franchisor with cash or other assets or to extend credit. Unfortunately, this probably applies to virtually every franchisor that is a subsidiary of another company, except where the franchisor is essentially an independently operating entity. If the parent does not want its litigation to be disclosed, it may have to set up the subsidiary as a completely independent operating entity that is fully self-sufficient from a financial standpoint. This could affect many franchise systems. Luckily, this provision only affects litigation disclosure and does not require financial statements to be attached.

Amended Item 21 requires the parent’s financials to be attached if the parent “commits to perform post-sale obligations for the franchisor or guarantees the franchisor’s obligations.” While the FTC helpfully clarified that the parent must commit to perform more than an isolated obligation to franchisees on behalf of the franchisor in order to trigger this requirement, this provision may affect many franchise systems where various services are provided for the franchisees by various parties affiliated with the franchisor. This provision will have the greatest impact on private companies that set up franchise subsidiaries to operate franchise systems because the parent did not want its financials disclosed and foreign franchisors that have set up a U.S. subsidiary to engage in franchising because their foreign financial statements are not

143 Section 11 of CA. S.B. 998.
144 Section 12 of CA. S.B. 998.
145 Illinois (§ 705/5(2)); Bus. Franchise Guide (CCH) ¶ 3130.05
prepared in accordance with U.S. GAAP. Perhaps an easy answer is to move the provision of the post-sale obligations to an affiliate.

If the parent commits to perform post-sale services for the franchisees and its financials have to be attached, the franchisor and its parent will have to decide whether there is any reason to prepare separate financials for the franchisor. The only reason to do so in such a situation is where the parent does not want to guarantee the franchisor’s obligations.

**B. Franchise Agreement Revisions**

In addition to reviewing the franchise program to determine if any restructuring is needed, franchisors will need to review their franchise agreements and other documents to determine whether any revisions are required. Perhaps the most needed review will be of the franchisor’s integration (entire agreement) clause to ensure that it complies with the Amended FTC Franchise Rule. In addition, if the franchisor plans to restructure so it does not have to include its parent’s financials in the disclosure document, the franchise agreements and other documents may have to be amended accordingly to the extent that they currently reflect that the parent is providing services to the franchisees, such as by redefining which third party entity may provide services or goods to the franchisees.

**VII. BUSINESS OPPORTUNITY LAWS**

**A. FTC Regulation**

The FTC has proposed a new, separate business opportunity rule. The existing portions of the original FTC Franchise Rule that apply to business opportunity sellers were moved into a rule of their own as of July 1, 2007. See 16 C.F.R. Part 437. The FTC’s proposed new business opportunity rule, if ever adopted, would amend 16 C.F.R. Part 437.

**B. State Laws**

Twenty-five states have business opportunity laws. In addition, the New York definition of “franchise” may be broad enough to cover certain business opportunity ventures. See New York (§681.3(a)); Bus. Franchise Guide ¶3320.02.


Most of those states have exclusions or exemptions that franchisors may use to avoid regulation, although some of those exclusions or exemptions are predicated on the franchisor having a federal or state trademark registration. A general discussion of those laws is beyond the scope of this paper, but we will address how some of those exclusions or exemptions may apply in light of, or be affected by, the promulgation of the Amended FTC Franchise Rule.

A number of states tie their exemptions into compliance with some version of the original FTC Franchise Rule (Alaska, Florida, Kentucky, Nebraska, Ohio, Texas and Utah), but their

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146 In addition, the New York definition of “franchise” may be broad enough to cover certain business opportunity ventures. See New York (§681.3(a)); Bus. Franchise Guide ¶3320.02.


148 Alaska (§ 45.66.220(2)); Florida (§ 559.802(1)(a)) (references old caption of original FTC Franchise Rule); Kentucky (§ 367.807(1)(a)) (references old caption); Nebraska (§ 59-1722(1)) (references old caption); Ohio (§ 1334.13) (references old caption); Texas (§ 41.004(b)(8)) (references 16 C.F.R. § 436.2(a)); Utah (§ 13-15-2(1)(b)); Bus. Franchise Guide (CCH) ¶¶ 3028.22; 3098.026; 3178.04; 3278.22; 3358.13; 3438.04; 3448.02, respectively.
references are generally broad enough to include the Amended FTC Franchise Rule because the citation in the C.F.R. has not changed. Unfortunately, Texas references the definition of “franchise” in 16 C.F.R. § 436.2(a) (now Section 436.1(h)).

Four business opportunity states tie their franchise exemption to the franchisor giving the buyer a disclosure document at the first personal meeting (Illinois, Iowa, Oklahoma and South Dakota). Those same four business opportunity states also tie their franchise exemption into the franchisor providing the prospect with a disclosure document 10 business days (Illinois, Oklahoma, South Dakota) or 14 days (Iowa) before execution of any agreements or payment of any consideration.

In some states, application of the states business opportunity law will not apply if the franchisor simply complies with the state’s franchise registration and disclosure law (California, Indiana, Maryland, Michigan, South Dakota, Virginia, Washington). In Minnesota, the business opportunity law is physically embodied in the Franchises Law.

Finally, some of the business opportunity exclusions or exemptions are predicated on the franchisor using a particular form of disclosure document, the references to which in many cases are outdated by the Amended FTC Franchise Rule or will be outdated by NASAA’s anticipated revisions to the UFOC Guidelines.

There does not appear to be any organized effort as of the date of this paper to synchronize the business opportunity laws with the Amended FTC Franchise Rule. However, some states may not take action against franchisors that comply with the Amended FTC Franchise Rule for what would otherwise be a violation of the state’s business opportunity law as a matter of policy. For example, Bob Tingler, Chief of the Franchise Bureau for the Illinois Attorney General’s Office, advised one of the authors that a representative of the Office of the Illinois Secretary of State, which administers the Illinois Business Opportunity Law, had advised him that if a franchisor complied with the Illinois Franchise Disclosure Act requirement of 14 days disclosure, the Secretary of State would not find a violation of the Business Opportunity Sales Law franchise exemption that refers to disclosure at the earlier of the first personal meeting or 10 business days before signing any agreements or paying any consideration.

149 Texas (§ 41.004 (b)(8)); Bus. Franchise Guide (CCH) ¶¶ 3438.04.

150 Illinois (§ 5-10(f)) (defines “personal meeting”); Iowa (§ 551A.4.1.b) (defines “personal meeting”); Oklahoma (§ 803.6) (defines “personal meeting”); South Dakota (§ 37-25A-3(5)); Bus. Franchise Guide (CCH) ¶¶ 3138.13; 3158.04; 3368.03; 3418.03, respectively.

151 Illinois (§ 5-10 (f)); Iowa (§ 551A.4.1.b.); Oklahoma (§ 803.6); South Dakota (§ 37-25A-3(6)); Bus. Franchise Guide (CCH) ¶¶ 3138.13; 3158.04; 3368.03; 3418.03, respectively.

152 California (§ 1812.201(b)); Indiana (§ 1); Maryland (§ 14-104(d)(3)); Michigan (§ 445.902(a)(iv)); South Dakota (§ 37-25A-2(3)); Virginia (§ 59.1-263.B.2); Washington (§ 19.110.040(2)); Bus. Franchise Guide (CCH) ¶¶ 3058.02; 3148.01; 3208.04; 3228.01; 3418.02; 3468.02; 3478.04, respectively.

153 Minnesota (§ 806.01, Subd. 4(a)(3)); Bus. Franchise Guide (CCH) ¶ 3230.01. The New York Franchises Law definition of “franchise” may be broad enough to reach many business opportunity schemes. New York (§ 681.3(a)), Bus. Franchise Guide (CCH) ¶ 7320.02.

154 Illinois (§ 5-10(f)) (references IFDA form or 1979 version of FTC Franchise Rule); Iowa (§ 551A.4.b) (references NASAA and 16 C.F.R. § 436 or any successor regulation); Nebraska (§ 59-1722(1)(b)) (references 16 C.F.R. 436 or then-current NASAA guidelines); Ohio (§ 1334.13) (references 1975 UFOC and 1977 Guidelines, and 16 C.F.R. 436.1) Oklahoma (§ 803.6) (references UFOC guidelines and 16 C.F.R. Section 436; South Dakota (§ 7-25A-3) (references UFOC under NASAA guidelines “as amended through September 21, 1983”); Bus. Franchise Guide (CCH) ¶¶ 3138.13; 3158.04; 3278.22; 3358.13; 3368.03, respectively.
VIII. PREPARING FOR THE CONVERSION

If a franchisor has not already started preparing for the conversion to the Amended FTC Franchise Rule format, there are several things the franchisor and/or its counsel should be doing right now:

1. Determine whether the franchisor will be able to take advantage of any of the new exemptions.

2. Determine if the expanded parent disclosures may apply to the franchisor and, if so, start preparing the parent disclosures for Amended Items 1, 3, 4 and 21.

3. If the expanded parent disclosures may apply to the franchisor, but it does not want to make the disclosures in Amended Items 3 and 21, consider whether it should restructure its franchise operations and how and when.

4. If parent financials are going to be attached, determine whether the franchisor will need its own separate audited financials or whether the parent is willing to guarantee the franchisor’s performance.

5. If the franchisor makes an earnings claim now, it should review its claim and consider what type of financial representations it may want to make going forward. Are there subsets it could use?

6. Assemble a list of all litigation the franchisor brought against its franchisees - for its prior fiscal year if it will be converting to the new format using a material change amendment, or for this fiscal year if it is not converting until renewal time.

7. Start gathering information for the new Amended Item 20 charts, and start preparing them now for the franchisor’s last two or three fiscal years.

8. Identify any franchise advisory councils the franchisor may have to list in Amended Item 20 and any independent franchisee associations that might ask to be included.

9. Determine if the franchisor has any confidentiality agreement/gag clauses that need to be disclosed.

10. Review the franchisor’s record retention policies and bring them into line with the Amended FTC Franchise Rule and state laws.

11. Determine if any of the franchisor’s officers have an interest in a supplier, because that will have to be disclosed in Amended Item 8.

12. Start briefing the franchisor’s sales staff on the Amended FTC Franchise Rule, but caution that the old rules apply until it switches formats.

13. And, start working on getting the UFOC or FDD ready now for electronic disclosure.
Also, see the article on “The Top Ten Things You Need to Know” which identifies some compliance considerations franchisors and/or its counsel should take into account.\textsuperscript{155}

IX. CONCLUSION

The Amended FTC Franchise Rule makes many welcome and necessary changes in the disclosure requirements, but the conversion to the new form of disclosure document presents opportunities and challenges. The conversion process is not likely to be as easy as it may appear to be, and franchisors would be well advised to allow sufficient time to review the new disclosure requirements and modify their disclosure documents accordingly. Franchisors that are in the habit of waiting until the last minute to update their disclosure documents on an annual basis may find that they will run out of time to complete the conversion in a timely manner so as to avoid a lapse in registration. Franchisors should treat the conversion process as a priority project and start working on revising their disclosure documents at an early date.

\textsuperscript{155} Gerald C. Wells and Dennis E. Wieczorek, “The Top Ten Things You Need to Know”, \textit{Franchise Law Journal}, Vol. 26, No. 4, pp. 163-165, 170 (Spring 2007).
Appendix A

AMENDED FRANCHISE RULE FAQs
Amended Franchise Rule FAQ’s

Amended Franchise Rule
16 C.F.R. Part 436

The following questions recently have been asked about the amended Franchise Rule. These questions will be addressed in the forthcoming Compliance Guide. Additional questions and responses will be posted periodically in order to assist franchisors in their review of the amended Rule requirements.

Please note that the opinions expressed below are those of the FTC staff charged with enforcement of the Franchise Rule. They have not been reviewed, approved, or adopted by the Commission, and they are not binding upon the Commission.

Questions

1. On July 1, 2007, franchisors may start to use the amended Franchise Rule. Does this mean that franchisors can use the amended Rule disclosure format only as of July 1, 2007, or does it mean that franchisors may also apply the non-disclosure provisions (such as timing provisions and prohibitions) of the amended Rule as well? For example, may a franchisor ignore the “first personal meeting” requirement after July 1, 2007, if the franchisor continues to use the UFOC Guidelines format?

2. On July 1, 2007, may franchisors furnish disclosures electronically even if they elect to use the original Rule or UFOC format?

3. Does the new large investment exemption apply to entities?

4. Must a franchisor include in its disclosure document the financials of its parent when the parent only sells goods or services to franchisees?

5. Item 3 of the amended Rule states that a franchisor must state it was “a party to any material civil action involving the franchise relationship in the last fiscal year.” At the same time, the Statement of Basis and Purpose for the amended Rule says that this disclosure of franchisor-initiated litigation covers only suits filed in the last fiscal year and needs to be updated only annually. Is the disclosure cumulative — that is, does the franchisor have to disclose any suit to which it is a party that was ongoing in the last fiscal year?

6. If a franchisor wishes to use the amended Rule on or after July 1, 2007, must it first amend its current UFOC or FTC disclosure document?

7. At times, a franchisor may pay existing franchisees a fee for referring leads to the franchisor. In such circumstances, are the existing franchisees acting as “franchise sellers” under the amended Rule? If so, are such existing franchisees subject to the amended Rule’s prohibitions section?

8. Item 19 of the amended Rule deletes the UFOC’s express permission to use performance results of substantially similar businesses of affiliates. Was this intentional? Does the amended Rule now prohibit the use of performance claims based upon affiliates?

9. Should “development agents” be treated as subfranchisors because they provide post-sale services to franchisees and, thus, must include financial statements and other information in the disclosure document?

10. Question: What constitutes a “fill-in-the-blank” provision for purposes of the requirement [§ 436.2(b)] that when a franchisor makes unilateral and material changes in the terms and conditions of an agreement, a prospective franchisee must receive the revised agreement at least seven calendar days signing? The Statement of Basis and Purpose indicates that material changes in the terms and conditions of do not include instances where “the only differences between the standard agreements and the completed agreements are ‘fill-in-the-blank’ provisions, such as the date, name, and address of the franchisee.” But might there be other “fill-in-the-blank” provisions that would not necessarily trigger the seven-day waiting period?

Specifically – with respect to a protected territory – can a franchisor avoid the seven-day waiting period by disclosing a general formula for determining a protected territory in the copy of the standard agreement attached to the disclosure document with a blank to be filled in later for the specific term in the actual franchise agreement that the parties will sign?

Similarly, could a franchisor avoid the seven-day waiting period by disclosing a range of initial fees, with a blank in the
amendment that the parties will sign to be filled in later for the exact fee?

11. Item 21 of the amended Rule permits a new franchisor to issue an unaudited initial balance sheet, so long as that balance sheet is "prepared in accordance with generally accepted accounting principles." What does that mean? In other words, what is the CPA's responsibility to verify the data, and what is the franchisor's responsibility in terms of the data used to prepare the statement?

12. The amended Rule requires franchisors to disclose on the Item 23 receipt page the "name, principal business address, and telephone number of each franchisee offering the franchise." Who is a "franchisee seller" for purposes of this disclosure? If at the time of furnishing the disclosure document a franchisee does not know the particular seller, such as a broker, what should Item 23 of the disclosure document say?

13. May a franchisor use separate charts in Item 17 for different types of franchise agreements?

14. The amended Rule prohibits a franchisor from failing, "upon reasonable request," to furnish a copy of its disclosure document to a prospective franchisee early in the sales process. What happens if a prospective franchisee asks for a copy of the disclosure document at a time when the franchisor is in the process of preparing its annual update or is awaiting registration in one or more of the registration states? Should the franchisor furnish a document that it knows will soon be updated with more current information?

15. How may a franchisor taking advantage of the amended Rule's disclosure provisions effectively comply with the Item 23 receipt requirement?

16. What is the scope of the "parent" disclosures, as set forth in Items 1, 3, 4, and 21 of the amended Rule?

Answers

1. On July 1, 2007, franchisors may start to use the amended Franchise Rule. Does this mean that franchisors can use the amended Rule disclosure format only as of July 1, 2007, or does it mean that franchisors may also apply the non-disclosure provisions (such as timing provisions and prohibitions) of the amended Rule as well? For example, may a franchisor ignore the "first personal meeting" requirement after July 1, 2007, if the franchisor continues to use the UFOC Guidelines format?

Answer: Since original promulgation of the Franchise Rule, the Commission has always permitted franchisors to comply either by following the provisions of the Franchise Rule itself, or by following the UFOC Guidelines. However, "mix-and-match" disclosures are not permitted: franchisors must use all of one set of requirements or all of the other set. They may not combine elements of the two different formats in a single disclosure document. This same policy will continue in effect on and after July 1, 2007. Franchisors will still have to select one set of disclosure requirement to follow, but they will have three options instead of just two. They can choose to follow either the original Rule, the UFOC Guidelines, or the amended Rule. Once they make a choice, they must be consistent, following the chosen set of requirements and none other until July 1, 2008, at which time the only format permitted will be the one prescribed in the amended Rule.

This means that a franchisor that chooses to comply with the original Rule on July 1, 2007, must continue complying with the "first personal meeting" provision, as well as other provisions unique to the original Rule — such as the five business-day contract review provision and separate earnings claims statement — until July 1, 2008.

Similarly, a franchisor that chooses to use the UFOC format on July 1, 2007, would not have to comply with any of the amended Rule's provisions — for example the amended Rule's integration clause prohibition — until July 1, 2008.

2. On July 1, 2007, may franchisors furnish disclosures electronically even if they elect to use the original Rule or UFOC format?

Answer: From July 1, 2007, until June 30, 2008, franchisors must select one and only one set of disclosure requirements: original Franchise Rule, amended Franchise Rule, or UFOC Guidelines. Technically, that would preclude a franchisor from furnishing disclosures electronically unless the franchisor opted to use the amended Rule — the only one of the three available sets of disclosure requirements that expressly permits electronic disclosure. Nevertheless, there are strong policy reasons for permitting franchisors to take advantage of technologies that offer the promise of reduced compliance costs, and the FTC staff would not recommend enforcement action against a franchisor that disclosed electronically and was otherwise in total compliance with either the UFOC Guidelines or the original Franchise Rule. This approach ensures that franchise purchasers receive adequate protection and at the same time conforms to the spirit of the Electronic Signatures in Global and National Commerce Act ("E-SIGN"), 15 U.S.C. 7001. Moreover, electronic disclosure is a method of delivery; it does not affect substantive disclosure requirements. Accordingly, for FTC purposes, all franchisors can begin using electronic disclosure on July 1, 2007. Of course, any franchisor electing to furnish disclosures electronically must follow the provisions for doing so set forth in the amended
3. **Does the new large investment exemption apply to entities?**

   **Answer:** The large investment exemption focuses on individuals and level of their investment, based on the rationale that a prospective investor able to invest at least $1 million (minus franchisor financing and the cost of unimproved land) is likely to be sophisticated and able to make an investment decision without federal government intervention. As noted in the Statement of Basis and Purpose, that rationale does not pertain when individuals, each investing only a small amount, combine in a group. Merely aggregating the small investments of a group of individuals does not transform the individuals into sophisticated investors. For that reason, the amended Rule requires that at least one individual in an investor group contribute at the $1 million threshold. The same analysis applies in the case of individual owners of an entity. In order to ensure that such owners are sophisticated, at least one individual owner must contribute at the $1 million threshold.

   The large investment exception, however, does not address how a qualifying individual may organize its business. Nothing in the amended Rule would preclude a qualifying individual contributing $1 million — and thus exempt from the amended Rule — from forming a partnership, corporation, or joining with a corporation or other entity, to operate the franchised outlet after signing the franchise agreement.

4. **Must a franchisor include in its disclosure document the financials of its parent when the parent only sells goods or services to franchisees?**

   **Answer:** The amended Rule requires separate financials for any "parent that commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations." Thus, this requirement would apply when the franchisor has an obligation to provide goods or services to franchisees, and that obligation is guaranteed or assumed by the franchisor's parent. If a parent happens to supply goods or services to franchisees where there is no underlying obligation on the part of the franchisor to supply them, then the parent is no different from any other third-party supplier and its financials need not be disclosed. On the other hand, if a franchisor is obligated to provide goods and services and the parent assumes that responsibility, or the franchisor arranges for the parent to provide goods and services directly to franchisees on its behalf, then the parent’s financials must be disclosed.

5. **Item 3 of the amended Rule states that a franchisor must state it was “a party to any material civil action involving the franchise relationship in the last fiscal year.” At the same time, the Statement of Basis and Purpose for the amended Rule says that this disclosure of franchisor-initiated litigation covers only suits filed in the last fiscal year and needs to be updated only annually. Is the disclosure cumulative — that is, does the franchisor have to disclose any suit to which it was a party that was ongoing in the last fiscal year?**

   **Answer:** The franchisor-initiated litigation disclosure is intended to capture suits that were *filed* by the franchisor in the last fiscal year. In that regard, "party to a material civil action . . . in the last fiscal year" means "party to any new material civil action filed in the last fiscal year." This disclosure, therefore, is not cumulative: pending suits *filed* by the franchisor against a franchisee more than a fiscal year ago need not be included.

   Accordingly, when preparing an annual update, the franchisor must disclose the suits it has filed against franchisees in the last fiscal year only (e.g., 2006 suits). Those suits must remain in the disclosure document used for the new fiscal year (e.g. 2007 disclosure document). No quarterly updating is required. Franchisors that initiate suits in the middle of a fiscal year or companies new to franchising can wait until their next annual update (e.g., 2008) to reference these new suits. At the beginning of each new fiscal year (e.g., 2008), the franchisor should delete the list of previously disclosed suits (e.g., 2006 suits) and substitute it with any new franchisor-initiated litigation filed in the most recently concluded fiscal year (e.g., 2007 suits).

6. **If a franchisor wishes to use the amended Rule on or after July 1, 2007, must it first amend its current UFOC or FTC disclosure document?**

   **Answer:** On or after July 1, 2007, franchisors may start using the amended Franchise Rule. By July 1, 2008, all franchisors must use the amended Rule format only. It is entirely at the discretion of each individual franchise system to decide when during the course of the phase-in period to make the conversion to the amended Rule format.

   Most likely, many franchisors will start using the amended Rule when they prepare their annual update. For example, we expect that many franchisors with a calendar-year fiscal year will start using the amended Rule in March or April of 2008, when preparing their annual update for 2008.

   Under the amended Rule, a franchisor need not amend its disclosure document immediately in order to start using the amended Rule. For example, a franchisor with a calendar-year fiscal year may decide on July 1, 2007, that it will start
using the amended Rule format on September 1, 2007, which falls within the third quarter of the franchisor’s fiscal year. The amended Rule requires franchisors to revise their disclosure document only quarterly. Accordingly, the franchisor need not revise its current disclosure document until the time for preparing a quarterly update, which, in the example, would fall in October, 2007.

Nonetheless, if the franchisor continues to sell franchises, it must furnish a quarterly update for the third quarter that contains all of the required disclosures set forth in the amended Rule. For example, the quarterly update must include the amended Rule’s more detailed Item 20 information. For that reason, franchisors, as a practical matter, may wish to amend their disclosure documents when they start using the amended Rule – even if they do so during a fiscal quarter rather than preparing detail quarterly updates until their next annual update.

Regardless of when it starts to update its disclosures, the franchisor in the example above must begin to comply with the amended Rule’s timing provisions and prohibitions on September 1, 2007. For example, even if the franchisor decides to update its disclosures through a quarterly update, it must immediately start on September 1, 2007, complying with the amended Rule’s non-disclosure provisions, such as timing provisions (e.g., disclosure earlier in the sales process upon reasonable request) and prohibitions (e.g., prohibition against inclusion of disclaimers or waivers).

7. At times, a franchisor may pay existing franchisees a fee for referring leads to the franchisor. In such circumstances, are the existing franchisees acting as “franchise sellers” under the amended Rule? If so, are such existing franchisees subject to the amended Rule’s prohibitions section?

Answer: Merely accepting compensation for referring leads to a franchisor, without more, is not enough to bring an existing franchisee within the amended Rule’s definition of “franchise seller” and, therefore, does not subject the franchisee to the amended Rule’s prohibitions.

This issue arises under the amended Rule’s definition of “franchise seller,” which includes brokers. The Statement of Basis and Purpose to the amended Rule states that a “broker” is a person who: “(1) is under contract with the franchisor relating to the sale of franchises; (2) receives compensation from the franchisor related to the sale of franchises; and (3) arranges franchise sales by assisting prospective franchisees in the sales process.” At the same time, the Statement of Basis and Purpose states that the term “broker” is sufficiently narrow to exclude existing franchisees who may refer potential franchisees to the franchisor because such individuals are not “under contract with the franchisor to sell franchises.” 72 Fed. Reg. 15,462 n. 169 (Mar. 30, 2007).

8. Item 19 of the amended Rule deletes the UFOC’s express permission to use performance results of substantially similar businesses of affiliates. Was this intentional? Does the amended Rule now prohibit the use of performance claims based upon affiliates?

Answer: 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 financial performance representation on affiliate information likely would not be “reasonable.” Nevertheless, in limited circumstances, a franchisor may base a financial performance claim upon the results of operations of the substantially similar business of an affiliate.

The question posed above refers to the following statement in the UFOC Guidelines’ instructions for Item 19:

“In the absence of an adequate operating experience of its own, a franchisor may base an earnings claim upon the results of operations of a substantially similar business of a person affiliated with the franchisor or franchisees or that person; provided that disclosure is made of any material differences in the economic or market conditions known to, or reasonably ascertainable by, the franchisor.”

The amended Rule does not incorporate this specific language; nevertheless, consistent with the UFOC Guidelines, the amended Rule does allow franchisors to use affiliate information as a basis for a performance claim in certain narrow circumstances – specifically, when the franchisor lacks an adequate operating experience of its own. However, as in the case of using any financial performance representation based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of such outlets that may differ materially from the outlets being offered for sale.

9. Should “development agents” be treated as subfranchisors because they provide post-sale services to franchisees and, thus, must include financial statements and other information in the disclosure document?

Answer: No. Even if a person performs post-sale 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). This is true regardless of the name given to the person, be it "development agent," "area developer," or "regional developer."

Staff’s determination as to whether a "development agent" should be considered a "subfranchisor" begins with consideration of how the amended Rule treats the term "subfranchisor." The amended Rule delineates the term "subfranchisor" within the definition of the term "franchisor," as follows:

_franchisor_ means any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors. For purposes of this definition, a "subfranchisor" means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance.

Thus, a "subfranchisor" is a person "who functions as a franchisor," by use of the qualifying phrases "grants a franchise" and "participates in the franchise relationship," the amended Rule clarifies that in order to be considered a subfranchisor, a party must have – as a franchisor has – (1) the authority to enter into a franchise agreement (or another agreement relating to the franchise), and (2) as a result of entering such an agreement, that party is obligated to perform after the purchase of the franchise is consummated.

The role of a subfranchisor is materially different from that of a broker, for example, because a broker typically is not a party to the franchise agreement and does not have post-sale contractual obligations to franchisees. In this regard, the amended Rule’s Statement of Basis and Purpose, in the discussion of Item 21 regarding subfranchisor financial information, states that "the term 'subfranchisor' is limited in the Rule to circumstances where the subfranchisor steps into the shoes of the franchisor by selling [franchisees] and performing post-sale obligations. It does not reach those individuals who may be called 'subfranchisors,' but who act like brokers, having no post-sale commitments to franchisees." 72 Fed. Reg. 15,511 (Mar. 30, 2007).

10. **What constitutes a “fill-in-the-blank” provision for purposes of the requirement [§ 436.2(b)] that when a franchisor makes unilateral and material changes in the terms and conditions of an agreement, a prospective franchisee must receive the revised agreement at least seven calendar days signing? The Statement of Basis and Purpose indicates that material changes in the terms and conditions of do not include instances where “the only differences between the standard agreements and the completed agreements are ‘fill-in-the-blank’ provisions, such as the date, name, and address of the franchisee.” But might there be other “fill-in-the-blank” provisions that would not necessarily trigger the seven-day waiting period?

Specifically – with respect to a protected territory – can a franchisor avoid the seven-day waiting period by disclosing a general formula for determining a protected territory in the copy of the standard agreement attached to the disclosure document with a blank to be filled in later for the specific term in the actual franchise agreement that the parties will sign?

Similarly, could a franchisor avoid the seven-day waiting period by disclosing a range of initial fees, with a blank in the agreement that the parties will sign to be filled in later for the exact fee?

**Answer:** In the Statement of Basis and Purpose, the Commission made clear that it will interpret “fill-in-the-blank” provisions narrowly. “To the extent that substantive contractual details – such as geographic area of a protected territory and interest rates – are not disclosed in the basic disclosure document or its attachments, then the completed document must be disclosed seven calendar days before signing.” 72 Fed. Reg. 15471 n.277 (Mar. 30, 2007). The seven-day waiting period ensures that, before entering into any franchise agreement or paying any related fee, a prospective franchisee can review and understand all material terms and conditions of the franchise arrangement. Accordingly, where the franchisor includes in the franchise agreement material terms that previously have not been disclosed or unilaterally changes material terms that previously have been disclosed, then the amended Rule requires that the prospective franchisee have at least seven calendar days to review the proposed revised agreement. This does not extend to non-substantive, fill-in-the-blank provisions.

Substantive terms of a franchise arrangement – such as fees, interest rate, and the parameters of a protected territory – must be disclosed in the agreement attached to the basic disclosure document or the franchisor must afford the prospect seven days to review the terms before signing or paying a fee. Of course, if the parties are negotiating such terms at the initiation of the prospect, then no additional waiting period is required.

On the other hand, with respect to protected territories, a franchisor may fill in a term in a franchise agreement without triggering the seven-day review period, provided the territory previously has been identified, but the exact name or circumstance was unknown at the time of disclosure. For example, if it is a franchisor’s practice to grant protected
territories on a county-wide basis, the franchisor may include a statement in its disclosure document to the effect that: “We assign protected territories by county. Your protected territory will be [name of county], in [state].” This sufficiently details the scope of the protected territory – an entire county – to enable the prospect to apply the statement to his or her specific proposed outlet without any further explanation. In the opinion of FTC staff, filling in the exact name of the county at a later date would not necessarily constitute a substantive change. Nevertheless, a vague description of a protected territory – such as a statement that the protected territory will range from 1 to 10 miles from the prospective franchisee’s outlet – is insufficiently detailed to give a prospective franchisee notice of the likely scope of his or her territory; filling in the exact number of miles at a later date, therefore, would be a substantive modification of the franchise agreement triggering the seven-day wailing period.

11. Item 21 of the amended Rule permits a new franchisor to issue an unaudited initial balance sheet, so long as that balance sheet is “prepared in accordance with generally accepted accounting principles.” What does that mean? In other words, what is the CPA’s responsibility to verify the data, and what is the franchisor’s responsibility in terms of the data used to prepare the statement?

**Answer:** While Item 21 permits start-up franchisors that do not already have audited financial statements to phase-in audited financial statements, it nonetheless states that franchisors must prepare audited financial statements as soon as practicable, and it instructs that an unaudited statement must be prepared “in a format that conforms as closely as possible to audited statements.” In the Statement of Basis and Purpose for the amended Rule, the Commission stated that an audit is not required for start-up franchisors, but financial statements nonetheless must conform to generally accepted accounting principles (“GAAP”). There is no requirement in the amended Rule that the opening balance sheet be prepared by an accountant, and it may well be the case that many start-up franchisors will not employ an accountant to prepare such balance sheets. While franchisors have flexibility in preparing such statements, in the opinion of FTC staff, a franchisor’s management would be expected to look to GAAP for guidance. For example, staff would expect an opening balance sheet to be in the format of a typical balance sheet prepared under GAAP and to include explanatory notes, where warranted, to ensure that the balance sheet is clear and accurate. In short, balance sheets must be in a format that conforms as closely as possible to audited statements prepared under GAAP. Further, to avoid any confusion with an audited balance sheet, the franchisor must clearly and conspicuously note that the balance sheet is unaudited.

12. The amended Rule requires franchisors to disclose on the Item 23 receipt page the “name, principal business address, and telephone number of each franchise seller offering the franchise.” Who is a “franchise seller” for purposes of this disclosure? If at the time of furnishing the disclosure document a franchisor does not know the particular seller, such as a broker, what should Item 23 of the disclosure document say?

**Answer:** A “franchise seller,” under the amended Rule is “a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor’s employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities.” As stated in the Statement of Basis and Purpose for the amended Rule, this disclosure provides prospective franchisees with contact information for any seller with whom they are dealing and is “also helpful for law enforcement purposes, identifying who may be responsible for furnishing the disclosures.”

When preparing the receipt page, franchisors should identify and include contact information for those particular sellers “offering the franchise.” That means those persons who have significant contacts with the prospective franchisee – for example, individuals assisting specific prospective franchisees in completing the application and other forms, or engaging in ongoing conversations with the specific prospective franchisees throughout the sales process. FTC staff believes, in particular, that any person who receives a sales commission and/or quota credit if the deal is consummated are the type of “franchise seller” who must be listed on the receipt.

The Statement of Basis and Purpose makes clear that this disclosure requirement is not intended to replicate Item 2 of the current UBOC Guidelines – that is, franchisors should not include a generalized list of all subfranchisors, brokers, or other individuals that may be involved in the sales process, but who do not have contacts with the individual prospective franchisee who will sign the receipt page. Nevertheless, FTC staff recognizes that the identity of a franchise seller may not be known at the time the franchisor furnishes the disclosure document. This is particular true if, under the amended Rule, the prospective franchisee takes advantage of the right to obtain a copy of the disclosure document early in the sales process.

A franchisor need not create an individualized disclosure document for each franchise sale. It is the FTC staff’s view that if, at the time of furnishing the disclosure document, a franchisor does not know the particular seller, such as a broker, the franchisor has several options. First, a franchisor could include an instruction in the receipt page that the prospective franchisee write in the name of the franchise seller before signing and returning the receipt page to the franchisor. Second, the franchisor could: (1) attach to the previously signed receipt a statement, business card, or
other document showing the name of the seller; and (2) send a copy of the attachment to the prospective franchisee so that the prospective franchisee has a copy of the completed receipt. At that point, both the franchisor and prospective franchisee will each have a copy of the same receipt. In short, in the FTC staff’s view, the absence of an identifiable seller at the time of disclosure should not force a delay in the prospective franchisee’s ability to sign the receipt page, provided that the receipt page is updated once the identity of the seller is known.

Finally, FTC staff notes that the amended Rule’s instructions require franchisors to retain for each completed franchise sale “a copy of the signed receipt for at least three years.” Staff expects that copies of signed receipts will include the required contact information for sellers, either because such contact information was filled in before the franchisor furnishes disclosures or was attached to the receipt once such contact information was known after the prospective franchisee signed the receipt.


2 Id.

13. May a franchisor use separate charts in Item 17 for different types of franchise agreements?

Answer: Yes. A franchisor always can use separate charts for different agreements (e.g., subfranchisee agreements), whether those be in Item 17, Item 20, or other disclosure items.

As noted in the Statement of Basis and Purpose, the amended Rule should be applied in a manner that is consistent with historic practices. For instance, with respect to this particular issue, the NASAA commentary on Item 20 specifically states that franchisors should use separate charts for statistics reflecting a subfranchisee’s region and for statistics reflecting national data for the franchise being offered. The use of separate charts for different agreements fosters precision and clarity, consistent with the goal of full and accurate disclosure.

14. The amended Rule prohibits a franchisor from failing, “upon reasonable request,” to furnish a copy of its disclosure document to a prospective franchisee early in the sales process. What happens if a prospective franchisee asks for a copy of the disclosure document at a time when the franchisor is in the process of preparing its annual update or is awaiting registration in one or more of the registration states? Should the franchisor furnish a document that it knows will soon be updated with more current information?

Answer: If a request for disclosures comes at a point in time when a franchisor is not obliged by section 436.7 to have just finished updating its disclosures, the franchisor may provide the then-current version of the disclosures, even if the disclosures will change with the next required update. For example, if the franchisor is in the middle of its fiscal quarter or is in the middle of the 120-day period after the close of its fiscal year for preparing an annual update, it may continue to provide prospects with its most current document. In order to avoid any possible misrepresentations, however, the “best practices” would be for the franchisor to inform the prospect that it is preparing revised disclosures and to make such revised disclosures available to the prospective franchisee when issued or registered. At the very least, however, the franchisor must provide copies of its updates to a prospect, upon reasonable request, before the prospect signs the franchise agreement.

The amended Rule, like the original Rule, provides specific times when a franchisor must furnish its disclosure documents. It also specifies when a franchisor must update its disclosures. But the amended Rule does not require a franchisor to update its disclosures continuously or immediately upon every new occurrence, or to stop selling until it has updated its disclosures. Accordingly, the franchisor may give out its then-current disclosure document pursuant to either the amended Rule’s 14 calendar-day disclosure requirement [§ 436.2(a)], or the amended Rule’s requirement to provide the disclosure document "earlier in the sales process than required under § 436.2 of this part, upon reasonable request." Nevertheless, in the latter instance, prospects who request and receive the disclosure document early in the sales process may not, when they are about to sign the franchise agreement, have the benefit of the most current information. Therefore, the Commission included § 436.9(f) in the amended Rule, which forbids a franchisor from failing to furnish a copy of its most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisee signs a franchise agreement.

15. How may a franchisor taking advantage of the amended Rule’s disclosure provisions effectively comply with the Item 23 receipt requirement?

Answer: The amended Rule permits franchisors flexibility in complying with the Item 23 receipt requirements. Below is the staff of the Commission’s view on three possible alternatives posed by practitioners.
A. Use of link to external receipt webpage

Section 436.6(d) of the amended Franchise Rule prohibits franchisors from including in any electronic disclosure document external links to materials outside of the disclosure document itself. The first requester proposes an exception to this prohibition for the limited purpose of facilitating compliance with the amended Rule's Item 23 receipt requirement. Specifically, he proposes that franchisors be permitted to place an icon (such as a "submit" or "submit receipt" button) on the Item 23 receipt page that links it to an external receipt webpage where the prospective franchisee could acknowledge receipt of the document. According to this proposal:

- The external receipt webpage would be accessible only from a link in either of the two receipt pages that are included within the electronic disclosure document;
- The external receipt webpage would include only an online form to be completed for the purpose of acknowledging receipt of the disclosure document. The content of the online form would be identical to that required under Item 23 of the amended Rule, adapted only to accommodate the online process (such as including instructions necessary for completing and submitting the form); and
- The external receipt webpage would contain no additional content or secondary links.

For the following reasons, FTC staff believes the proposed limited use of an external link to a web-based receipt page, as described above, is permitted under the amended Rule, because it is consistent with the goal of permitting electronic disclosure and does not diminish the level of protection the amended Rule provides to prospective franchisees.

As noted above, the amended Rule prohibits the use of external links. This prohibition is necessary to preserve the integrity of a disclosure document. Without this prohibition, nothing would prevent a franchisor from including external links to materials that are either false or deceptive, that contradict the franchisor's authorized disclosures, or that are not required or permitted by either federal or state franchise disclosure laws. Nevertheless, § 436.6(d) of the amended rule does allow inclusion of scroll bars, internal links, and search features "for the sole purpose of enhancing the prospective franchisee's ability to maneuver through an electronic version of a disclosure document."

As proposed in the requester's letter, the external link to a webpage accessible only to recipients of a disclosure document would facilitate compliance with the Item 23 receipt requirement. The proposed webpage would be identical to the Item 23 receipt page, with the addition of instructions for submitting the receipt. This is consistent with amended Rule Item 23, which permits franchisors to include instructions for submitting the receipt in the receipt page itself. Finally, this proposal ensures that no other links or materials will be accessible from the webpage, thereby preventing access to materials that may be deceptive or false, contradictory, or not required or permitted in a disclosure document by federal or state law. Accordingly, in the opinion of FTC staff, it would not violate the amended Rule for a franchisor to include a link in the receipt page to a webpage that facilitates submission of the Item 23 receipt provided that: (1) the web-based receipt page is accessible only by prospective franchisees from Item 23 of an electronic disclosure document; and (2) no other content or external links are included in the web-based receipt other than information required or permitted by Item 23 of the amended Rule (i.e., instructions for submitting the receipt).

B. Icon enabling prospective franchisees to print receipt page

A second requester suggests that franchisors be permitted to include an icon on the electronic receipt page, that, when pressed, would enable the prospect to print out a copy of just the receipt, which could then be signed and mailed or faxed to the franchisor. This would facilitate compliance with the Item 23 receipt requirement by enabling prospects to print out the receipt without printing out the entire disclosure document. In the opinion of FTC staff, this is an acceptable method of ensuring compliance with the amended Rule's receipt page requirement.

C. Separate receipt page attachment

Finally, a third requester suggests that franchisors be permitted to email a prospect two documents: (1) the basic disclosure document; and (2) a separate receipt page that could be printed out, signed, and returned to the franchisor. In FTC staff's opinion, this would not be an acceptable method of complying with the Item 23 receipt page requirement because, it would be possible for a prospect to open nothing but the separate receipt page. In such an instance, there would be no proof that the prospect, in fact, was able to open and had the opportunity to review the disclosure document itself. The scenario proposed by the third requester could easily be modified, however, using one of the two methods posited by the other two requesters that are discussed above – inserting a link to a separate web-based receipt page in the text of the Item 23 receipt itself, or including an icon in the Item 23 receipt that enables a prospect to print out just the receipt page. Either of these two approaches would ensure that each prospect submitting a receipt
had, in fact, opened the electronic disclosure document.

16. **What is the scope of the “parent” disclosures, as set forth in Items 1, 3, 4, and 21 of the amended Rule?**

**ANSWER:** The scope of the “parent” disclosures in the amended Rule varies depending upon the specific disclosure items. Below, FTC staff addresses specific questions that have been raised regarding the parent disclosures found in Items 1, 3, 4, and 21 of the amended Rule. As an initial matter, the original Franchise Rule, unlike the Uniform Franchise Offering Circular (“UFOC”) Guidelines, always has required the disclosure of parent information, even though the states do not require the disclosure of such information. Accordingly, in large measure, the amended Franchise Rule retains these provisions from the original Rule, with some modifications, as discussed below.

Before addressing the specific parent disclosures set forth in the amended Rule, FTC staff notes the definition of “parent” set out at section 436.1(m): “an entity that controls another entity directly, or indirectly through one or more subsidiaries.” The definition 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.

**A. Item 1: Identity of any parents**

One question is whether the term “parent” in Item 1 is intended to be interpreted narrowly to cover only the “ultimate parent that controls all the subsidiaries.” Item 1 requires franchisors to disclose “[t]he name and principal business address of any parents.” The use of the word “parents” is intentional, anticipating that a franchisor may be required to disclose one or more parents, provided that such parents control the franchisor. This issue is addressed in the SBP. There, the Commission made clear that a franchisor must disclose all parents, including intermediate parents, specifically rejecting the suggestion that only the ultimate parent be disclosed.

This does not mean that a franchisor must disclose all parent-entities in the chain of ownership of the franchisor. Rather, the franchisor must disclose only those parents that in fact exercise control over the policies and direction of the franchise system, consistent with the definition of parent, as mentioned above. As the Commission noted in the Statement of Basis and Purpose (“SBP”), the disclosure of parents — meaning those entities that control the franchise system — is necessary to “ensure that a prospective franchisee understands who may control or influence the franchisor’s operations.” For many franchise systems, this may mean the “ultimate parent,” but such determinations can be made only on a case-by-case basis depending upon the particular facts.

**B. Item 3: Litigation**

Another question asks about the scope of the obligation to disclose parent litigation. Preliminarily, FTC staff notes that Item 3 specifies that litigation of a parent is required only if the parent “induces franchise sales by promising to back the franchisor financially or otherwise guarantees the franchisor’s performance.” Specifically asked is what difference, if any, exists between “financial backing,” on the one hand, and “guaranteeing performance,” on the other.

“Financial backing” here is intended to refer to promises that a parent may make to ensure that the franchise system is and remains on stable financial footing. Typically, this would mean that the parent 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.

On the other hand, “guaranteeing 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 its 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.

**C. Item 4: Bankruptcy**

Another question asks whether the use of singular term “parent” in the Item 4 bankruptcy disclosures is meant to be distinct from the plural term “parents” in Item 1. Specifically asked is whether, for Item 4 purposes, it is sufficient to disclose only the ultimate parent’s prior bankruptcy, or must intermediate parents be disclosed as well.

The disclosure of parent information in Item 4 is intended to be consistent with that of Item 1. If any of the parents listed in Item 1 have had a bankruptcy in the relevant time period, then that information must be disclosed in Item 4. Indeed, in the SBP, the Commission specifically rejected comments suggesting that parent bankruptcy disclosures are
unwarranted, finding that parent information is material. The Commission noted, for example, that when a parent is in bankruptcy 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."4

D. Item 21: Financial statements

Item 21 requires the disclosure of parent financials if the parent “commits to perform post-sale obligations for the franchisor or guarantees the franchisor’s obligations.” A question posed is whether the phrase “post-sale obligations for the franchisor” is intended to capture only those obligations that benefit franchisees, noting that a parent may agree to perform “back office services for the franchisor’s own internal purposes.”5 In the opinion of FTC staff, the disclosure of parent financial information is required only when the franchisor’s parent commits to perform post-sale obligations for the direct benefit of franchisees. Agreements between a franchisor and its parent for administrative and other services for the franchisor’s internal purposes do not trigger the parent financial disclosure requirement.6

Another question is whether the requirement that a parent disclose its financials is triggered by any commitment to perform on behalf of the franchisor or whether the requirement is triggered only if the parent commits to perform something more, such as committing to perform substantial post-sale obligations or a preponderance of the post-sale obligations that have to be provided to the franchisee.

As noted above, the amended Rule requires parent financial statements where the parent commits to perform or guarantees the franchisor’s obligations. FTC staff believes that the use of the plural “obligations” was intended to convey that the performance of a single or isolated obligation alone is insufficient to trigger the parent financials disclosure. At the same time, Item 21 sets forth no specific threshold standard, such as “substantial obligations,” or “preponderance of obligations.” Accordingly, FTC staff would expect a parent to disclose its financials if it commits or guarantees to perform more than an isolated obligation to franchisees on behalf of the franchisor.

2 Id. n.317. Only the identity of the parent(s) need be disclosed in Item 1. As discussed in the SBP, “[i]n contrast with the Item 1 disclosures for affiliates and predecessors, a franchisor need not disclose, for example, the parent’s business background, length of time selling franchisees or engaging in other lines of business.”
3 Id.
5 An additional question is whether Item 21 requires the disclosure of an affiliate’s financials, if the affiliate commits to perform post-sale obligations for the franchisor. The amended Rule makes clear that the disclosure of an affiliate’s financials is voluntary, if the affiliate “absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement.” 16 C.F.R. § 436.5(u)(1)(ii). Accordingly, a parent need not disclose financials unless it qualifies as a “parent” and commits to perform or guarantees the franchisor’s post-sale obligations.
6 A related question is whether the parent financials disclosure would be triggered if a parent’s employees perform services on behalf of a franchisor. Arguably, such services are akin to providing back office support for the franchisor. In other words, is the Item 21 parent financials disclosure obligation limited to where the parent commits to perform obligations directly for the benefit of franchisees under the name of the parent company – meaning that franchisees are specifically looking to the parent company to provide those services (and not simply because an employee of the parent working for the franchisor provides some service for the franchisee)? In the opinion of FTC staff, the Item 21 parent financial disclosures are intended to cover formal arrangements between the parent and franchisor for the benefit of franchisees or formal arrangements directly between the parent and franchisees. The performance of post-sale obligations by a parent’s employee for the benefit of franchisees does not trigger the Item 21 parent financial disclosures, absent a formal commitment or guarantee on the part of the parent to perform.
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John R. F. Baer is a partner in the Chicago office of Sonnenschein Nath & Rosenthal LLP. Mr. Baer has a broad transactions practice with extensive experience representing companies engaged in franchising and distribution, including the use of sales representatives, both domestically and internationally. His practice covers a wide range of other related areas, including commercial, sales, warranties, product safety and regulatory matters. Mr. Baer has spoken and written extensively on both domestic and international franchise issues.

Mr. Baer is Chair of the Illinois Attorney General’s Franchise Advisory Board and Editor of the CCH Sales Representative Law Guide. From August 2003 to August 2006, he was a member of the Governing Committee of the ABA Forum on Franchising. He is the Secretary of the International Franchising Committee of the International Bar Association’s International Sales, Franchising and Product Law Section. Mr. Baer is a member of the Industry Advisory Committee to the North America Securities Administrators Association Franchise Project Group. He is a member of the Legal/Legislative Committee of the International Franchise Association and on the Board of Editors of LJN’s Franchising Business & Law Alert. He is also a member of the Editorial Board of the Canadian Franchise Review and a member of the Editorial Advisory Board of the International Journal of Franchising Law. Mr. Baer formerly was the Editor-in-Chief of the ABA Forum on Franchising’s The Franchise Lawyer, an Associate Editor of ABA Forum on Franchising’s Franchise Law Journal, the Publications Officer of the ABA Forum on Franchising, a co-author of a quarterly column on international franchise developments for the World Franchise & Business Report, and a Vice President of the Franchising Committee of Union Internationale des Avocats.

Shelley Harris-Horn

Shelley Harris-Horn is the Lead Franchise Examiner in the Franchise Bureau of the Office of the Attorney General for the State of Illinois. As Lead Examiner with 29 years (yes 29 - surely I don’t reflect the appearance of those 29 years, right?) of franchise experience, Shelley, is totally immersed in the daily functions of the Franchise Bureau, with regulatory procedures and enforcement actions focused upon. Assisting the Bureau Chief and other Franchise Examiners in the decision making process and policy analysis and development ensures Shelley’s continued, active involvement in the various aspects of bureau operations.

Shelley participates annually at the NASAA Franchise Examiner training programs and has been very active in NASAA’s coordinated review/registration program as well as others. Shelley has also spoken at various programs sponsored by the American Bar Association Forum on Franchising and the International Franchise Association.

Beyond the franchising world, Shelley shares responsibility for an expanding automotive business with her husband. Shelley’s hands-on business perspective provides for an all encompassing involvement with the business, in general, and accounting operations, regulatory compliance, employee management, and expansion plans, primarily.

Apparently not challenged enough with all her activities, Shelley’s most recent venture has been the opening of penache boutique with a corresponding online web store and a new field of entrepreneurship. This multi-faceted background has proven invaluable to Shelley’s responsibilities in the Franchise Bureau since it enables her to comprehend the business environment while balancing franchisor perspective with regulatory requirements.
Steven Toporoff

Steven Toporoff is an attorney in the Division of Marketing Practices, Bureau of Consumer Protection, Federal Trade Commission. Since 1993, he has been the principal attorney responsible for coordinating the Commission=s Franchise Enforcement Program. These responsibilities include monitoring franchise complaints and legal developments; generating and litigating franchise enforcement actions; assisting FTC regional offices, federal agencies, state and local governments, and consumer advocacy organizations on franchise matters; preparing staff advisory opinions; and developing consumer and business education materials. He also coordinates the Commission=s Franchise Rule Alternative Law Enforcement Program.

Steven also led the Commission=s Franchise Rule amendment project. Among other things, he organized numerous notice and comment periods and public workshop conferences on franchise issues, culminating in the issuance of the Staff Report on the Franchise Rule in 2004 and the amended Franchise Rule and Statement of Basis and Purpose in January 2007. Currently, he is preparing a Compliance Guide on the Franchise Rule and revising the Commission=s Consumer Guide to Buying a Franchise.

Steven has also been an advisor to the U.S. Department of State, and he was a member of the U.S. delegation that negotiated the UNIDROIT Model Franchise Disclosure Law. He has also appeared as an expert witness on behalf of the U.S. Department of Justice. See U.S. v. Parker, 364 F.3d 934 (8th Cir. 2004). He is also an ex officio member of NASAA=s Franchise and Business Opportunity Project Group.

Steven has spoken at numerous programs on franchising and related issues sponsored by organizations such as the ABA Anti-Trust Section, Franchise and Distributorship Committee; ABA Forum on Franchising; American Franchisee Association; American Intellectual Property Law Association; Direct Selling Association; DC Bar Association; European Franchise Federation; Federal Bar Association; International Franchise Association; Maryland Institute for Continuing Professional Education of Lawyers (MICPEL); Michigan State Bar Association; New York State Bar Association; Minority Business Development Agency; North American Securities Administrators Association (NASAA); and the United States Department of Health and Human Services. He has also addressed numerous foreign delegations on franchise and consumer protection matters, including representatives of Australia, Canada, China, Egypt, England, Estonia, Hungary, Indonesia, Japan, Latvia, Macedonia, South Korea, Peru, Russia, Sweden, Thailand, and Tunisia.