FUNDAMENTAL CHANGE OR FINE-TUNING?:
THE NEW FTC FRANCHISE RULE

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October 19 – 21, 2005
The JW Marriott Grande Lakes Resort
Orlando, Florida

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I. BACKGROUND ..................................................................................................................1

II. THE MOST SIGNIFICANT CHANGES PROPOSED BY THE STAFF REPORT ...........2
   A. The Cover Page - Proposed Section 436.3...............................................................2
   B. Electronic Disclosure – Proposed Sections 436.2(c), 436.6(a), (c) and (f)...........2
   C. Exemptions – Proposed Sections 436.8(5), (6).......................................................3
   D. Person Liable – Proposed Sections 436.1(i), 436.2(d) and 436.9.........................4
   E. Franchisor Initiated Litigation – Proposed Section 436.5(c) - Item 3....................4
   F. Parent Disclosures ...............................................................................................4
   G. Financial Performance Representations – Proposed Sections 436.1(e) and 436.5(s) - Item 19 ..........................................................................................5
   H. Franchisee Associations – Proposed Section 435.1(t)(8) - Item 20 .................6
   I. Store Counts - Proposed Section 435.1(t)(1-6) - Item 20.....................................7
   J. Confidentiality and Integration Clauses - Proposed Sections 435.1(t)(7) and 436.9(i) - Item 20 ...........................................................................................7
   K. Material Information/Updating Requirements - Proposed Sections 436.10(a) and 436.7 .............................................................................................8
   L. Pre-emption - Proposed Section 435.10(c) ...........................................................8
   M. Key Differences Between the FTC Proposal and Current UFOC Guidelines .................................................9

III. WHAT DIDN’T CHANGE................................................................................................12
   A. Overview ............................................................................................................12
   B. Financial Performance Disclosure..................................................................12
   C. Remedies ...........................................................................................................13
   D. Relationship Regulation ....................................................................................13
   E. International .......................................................................................................14
   F. Multi-branding ..................................................................................................14

IV. IMPLICATIONS OF THE STAFF REPORT ................................................................14
   A. Implications for Franchisees...............................................................................15
   B. Implications for Franchisors ...............................................................................20
   C. Implications for Franchisor Lawyers ...................................................................30
   D. Implications for NASAA ...................................................................................37
I. BACKGROUND

The Federal Trade Commission’s Trade Regulation Rule on Franchising and Business Opportunities Ventures (C.F.R. Part 436; the "Rule") became effective in October, 1979 after nearly ten years of investigative effort and formal rule-making process. In 1995, the FTC began what has become a 10 year (and counting) investigative and rule-making process to review and update the Rule. In August, 2004, FTC Staff filed a report (the "Staff Report") recommending several revisions to the Rule.

This paper examines a selected list of what the authors perceive to be the more significant elements of the Staff Report in order to evaluate whether, and if so, the extent to which, the Rule revisions recommended in the Staff Report, if adopted by the FTC, will materially impact prospective franchisees, franchisors, franchisor lawyers, and NASAA and the familiar 1993 version of the Uniform Franchise Offering Circular.

This paper is descriptive and evaluative, not critical, of selected elements of the Staff Report. We do not undertake to identify every change recommended in the Staff Report, or to critique the Staff Report. Part II identifies our selected list of 12 significant changes proposed by the Staff Report; Part III mentions briefly a few franchise disclosure practices and requirements that could have changed based upon the FTC’s investigation of the Rule but did not; and Part IV evaluates the implications of the Staff Report and the Rule revisions that it proposes for various participants in the field of franchising. We do not draw final conclusions; no section of this paper is titled "Conclusion." Rather, that is left to the Federal Trade Commission, which remains free to adopt the Staff Report as presented, adopt it with modifications, reject it, or remand it for further study.

The authors acknowledge the invaluable research assistance of Zeviel Simpser of Briggs and Morgan, P.A.

1 With one minor exception, all of the state franchise presale registration and disclosure laws were enacted between 1970 and 1975.

2 See, Part II, infra.

3 See, Bus. Franchise Guide (CCH) ¶ 12,880.

4 The North American Securities Administrators Association, a trade association of U.S. and Canadian state and provincial securities law administrators, has carried responsibility (as successor to the Midwest Securities Commissioners Association) for the UFOC disclosure requirements since 1974.

5 See, Bus. Franchise Guide (CCH) ¶¶ 5750 – 5850. The first UFOC was developed in 1973-74 by the franchise administrators in several states in the upper Midwest (through the Midwest Securities Commissioners Association, later merged into NASAA) to facilitate multistate registration and disclosure compliance. It was, in effect, the lowest common denominator of the participating states’ statutory disclosure obligations in effect at the time. Despite the attenuated relationship between the state statutes and the UFOC and its Guidelines, the UFOC quickly took on a life of its own and achieved nearly universal use and acceptance. In 1979, the FTC acknowledged the UFOC and accepted it as an alternative means of compliance with the Rule’s disclosure mandate. The Staff Report reiterates that endorsement, and embraces a slightly modified version of the UFOC for Rule compliance. Staff Report at 14 – 16.

6 The FTC has not yet responded to the public comments to the Staff Report, but the FTC staff has said informally that it plans to make only fine-tuning changes to the proposed Rule based on the last round of public input.
II. THE MOST SIGNIFICANT CHANGES PROPOSED BY THE STAFF REPORT

The Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule dated August 25, 2004 is nearly the last step in an almost decade long review of the Rule. The process began with a Rule Review commenced on April 7, 1995\(^7\), followed by an Advanced Notice of Proposed Rulemaking ("ANPR") issued on February 28, 1997\(^8\) and a Notice of Proposed Rulemaking ("NPR") issued on October 22, 1999\(^9\).

The following Sections A through L summarize what we consider to be the top dozen most significant changes to the Rule that will occur if the Federal Trade Commission adopts the Proposed Rule (Attachment B to the Staff Report) without modification. Section M outlines key differences between the Proposed Rule and the current (1993) version of the UFOC disclosure requirements and guidelines

A. The Cover Page - Proposed Section 436.3

1. Language suggesting greater oversight of franchising by the FTC than is the case has been deleted.

2. Risk Factors need not be included.

3. The Franchisor’s e-mail address and primary world wide web home page must be disclosed.

4. References to the FTC’s website and its publication, “A Consumer’s Guide to Buying a Franchise” have been added.

5. An invitation to request that the disclosure document be provided in a different format that may be more convenient for the prospective franchisee.

6. Additional disclosures may be included to the extent required to comply with state presale disclosure laws.

B. Electronic Disclosure – Proposed Sections 436.2(c), 436.6(a), (c) and (f)

1. The disclosure document may be furnished:

   a. By hand delivery, fax, e-mail or otherwise, if by the required date;

   b. On the Internet, if the prospective franchisee was provided with directions for doing so by the required date; or

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\(^7\) 60 Fed. Reg. 17,656 (April 7, 1995).

\(^8\) 62 Fed. Reg. 9,115 (February 28, 1997).

c. By sending a paper or a tangible electronic copy (computer disk or CD ROM) by first class mail at least three days before the required date.

2. The disclosure document must be in a form that permits the prospective franchisee to store, download, print, or otherwise maintain the document for future reference.

3. The franchisor must advise the prospective franchisee of the formats in which the disclosure document is made available, as well as any conditions or prerequisites for obtaining the disclosure document in a particular format.

4. Electronic versions of the disclosure document may have scroll bars, internal links and search features; but audio, video, animation, external links and pop-up screens are prohibited.

C. Exemptions – Proposed Sections 436.8(5), (6)

1. Size of Investment

Disclosure is not required if:

a. The estimated investment exceeds $1 million, excluding
   i. Financing from the franchisor or its affiliate, and
   ii. Real estate costs; and

b. The franchisee signs an acknowledgement verifying the grounds for the exemption.

2. Qualified Investor

Disclosure is not required if the prospective franchisee has been in business for 5 years and has a net worth of at least $5 million.

3. Franchisor Insiders

Disclosure is not required if one or more purchasers with combined ownership of at least 50% has:

a. Two years of management responsibility for the sale of the franchisor’s franchises or the administration of the franchised network; or

b. For two years has been an owner of at least 25% of the franchisor.

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10 The text of the proposed Rule refers to “…the offer and sale of the franchisor’s franchisees…”
D. **Person Liable – Proposed Sections 436.1(i), 436.2(d) and 436.9**

1. All franchise sellers who participate in the preparation of the disclosure document are liable under Section 5 of the FTC Act for any failure to comply with the requirements relating to the contents and updating of such disclosure document.

2. All franchise sellers are liable for the commission of any of the unfair and deceptive acts or practices enumerated in proposed Section 436.9.

3. A franchise seller is defined as:
   a. A person that offers for sale, sells or arranges for the sale of a franchise; and
   b. The franchisor’s employees, representatives, agents, subfranchisors and third party brokers who are involved in franchise sales activities.

E. **Franchisor Initiated Litigation – Proposed Section 436.5(c) - Item 3**

1. Franchisor-initiated litigation commenced within the past year only must be disclosed (in addition to the traditional Item 3 litigation).

2. Franchisor-initiated litigation may be grouped under one common heading which will serve as the summary of the legal and factual nature of the claim (e.g., royalty collection suits).

3. Annual updating only is required.

F. **Parent Disclosures**

1. **The Franchisor- Proposed Section 436.5(a) - Item 1**
   a. The franchisor’s parent must be disclosed.
   b. Disclose the business experience of a parent that provides products or service to the franchisees or sells franchises in any line of business.

2. **Business Experience – Proposed Section 436.5(b) - Item 2**
   a. Disclose the business experience of executives of the parent who exercise management responsibility regarding the sale or operation of franchises of the franchisor.

3. **Litigation – Proposed Section 436.5(c) - Item 3**
   a. Disclose parent litigation if the parent guarantees the franchisor's performance.
   b. Disclose parent-initiated litigation even if the parent is not a guarantor of the franchisor.
4. **Bankruptcy – Proposed Section 436.5(d) - Item 4**
   a. Disclose any bankruptcy of the parent.

5. **Financial Statements – Proposed Section 436.5(u) - Item 22**
   a. The franchisor may disclose, in lieu of financial statements of the franchisor, the financial statements of a parent that guarantees the franchisor’s performance.
   b. The franchisor must disclose the financial statements of a parent that guarantees the franchisor’s performance or commits to perform post-sale obligations of the franchisor.
   c. Include a copy of the guarantee in either case.

G. **Financial Performance Representations – Proposed Sections 436.1(e) and 436.5(s) - Item 19**
1. Item 19 disclosures remain voluntary with the franchisor, and if a franchisor elects to offer financial performance information, it may choose the type(s) or category(ies) of information to disclose. The catchphrase "earnings claims" is replaced by "financial performance representations."

2. A franchisor’s dissemination of expense information alone will not be deemed the making of a financial performance representation.

3. **Mandatory disclosures**
   a. In all cases:

   The FTC’s Franchise Rule permits a franchisor to disclose information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about performance at a particular location or under particular circumstances.

   b. Where no financial performance representation is made:

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

4. All financial performance representations must have a reasonable basis and written substantiation.

5. Historic financial performance representations are distinguished from a forecast of the prospective franchisee’s future financial performance.

6. Written substantiation for the financial performance representation must be made available to the prospective franchisee upon reasonable request.

7. A franchisor need not comply with Item 19 for disclosures of the actual operating results for a specific outlet being offered for sale, provided the information is given only to potential purchasers of that outlet.

8. A franchisor that furnishes financial performance information may deliver a written supplemental financial performance representation about a particular location or variation, apart from the disclosure document, which must explain the departure from the financial performance representation in the disclosure document.

H. Franchisee Associations – Proposed Section 435.1(t)(8) - Item 20

1. Disclose trademark-specific franchisee associations associated with the franchise system being offered, including:

   a. Those created, sponsored or endorsed by the franchisor, and

   b. Those that are incorporated and ask to be included in the disclosure document.

      i. The request for inclusion must be renewed annually within 90 days before the end of each fiscal year.

      ii. The franchisor need not verify the existence of the association after each fiscal year.

      iii. Disclose name, address, telephone number, e-mail address and Web address of the association.

The franchisor may include a disclaimer that the association may not represent all franchisees in the franchise system.
I. **Store Counts - Proposed Section 435.1(t)(1-6) - Item 20**

1. New Systemwide Outlet Summary.
   a. Three year growth.
   b. Franchised and company-owned outlets.

2. Double counting eliminated.
   a. Last in time approach to be used for units with multiple events (e.g., reacquired then closed).

3. Status of Franchised Outlet chart tracks 5 categories of events with totals for the start and end of each year.

4. Status of Company-Owned Outlet chart tracks 4 categories of events with totals for the start and end of each year.

5. For each sale of a specific existing unit to a franchisee, disclose the history of that unit for the last five fiscal years\(^{11}\), including names, addresses and telephone number of each previous owner, the period of ownership, the reason for the change, and the time period(s) when the franchisor retained control of the outlet.

J. **Confidentiality and Integration Clauses - Proposed Sections 435.1(t)(7) and 436.9(i) - Item 20**

1. **Confidentiality Clauses**
   a. Disclose if such clauses were signed in the last three years in a franchise agreement, settlement or in any other contract.
   b. If so, provide a statement that such agreements may restrict current and former franchisees from speaking openly about their experiences in the system and that while the FTC encourages the prospective franchisee to speak with current and former franchisees, not all such franchisees will be able to speak.
   c. The franchisor may disclose the number and percentage of franchisees who signed such clauses with the last three years and the circumstances of such signings.

\(^{11}\) The Staff Report states at page 181 that "Consistent with the II AG’s proposal, we recommend that this information be disclosed for the last three fiscal years ...". The text of the Proposed Rule states at Section 436.6(t)(4) that the additional information regarding the sale of an existing franchise outlet is to be provided “…for the last five fiscal years”. We are advised by FTC Staff that the text of the proposed Rule is correct and that such information must be provided for the last five fiscal years.
2. **Integration Clauses**

   a. The franchisor may not disclaim any of the representations made in the disclosure document.

   b. The franchisor may not require a prospective franchisee to waive reliance on any of the representations made in the disclosure document.

   c. The franchisee may voluntarily waive specific contract terms and conditions in the disclosure document during the course of franchise sale negotiations.

K. **Material Information/Updating Requirements - Proposed Sections 436.10(a) and 436.7**

1. **Material Information**

   a. Franchisors may have additional obligations to disclose other material information to prospective franchisees going beyond the enumerated Rule requirements, under Section 5 of the FTC Act.

   b. The FTC intends to enforce all applicable laws and trade regulation rules.

2. **Updating Requirements**

   a. An updated disclosure document must be used starting 120 days after the close of the franchisor’s fiscal year.

   b. Revisions reflecting material changes in the franchisor or the business of the franchisor must be attached to the disclosure document within a reasonable time after the close of each calendar quarter.

   c. Each annual update of the disclosure document must include the first quarterly update.

   d. The franchise seller must notify a prospective franchisee who received an earlier version of the UFOC of any material change the seller knows or should have known occurred in the information contained in any financial performance representation made in Item 19.

   e. Quarterly financial statements of the franchisor need not be audited.

L. **Pre-emption - Proposed Section 435.10(c)**

1. The FTC does not intend to preempt the franchise practices laws of any state, except to the extent of any inconsistency with this Rule.
2. State law that provides prospective franchisees with equal or greater protection, such as registration of disclosure documents or more extensive disclosures, is not inconsistent.

M. **Key Differences Between the FTC Proposal and Current UFOC Guidelines**

There are two immediate distinctions between the revised Rule and the UFOC Guidelines:\(^\text{12}\) their scope, and source of authority.

As for scope, the revised Rule, like the current Rule, reflects the entire landscape of federal regulation of franchise sales. It covers far more than the mandatory content of the presale disclosure document, which is the lone subject of the UFOC Guidelines. In addition to addressing jurisdiction and coverage through definitions, exemptions, exclusions and a provision confining application of the revised Rule to the U.S., its territories and possessions, the revised Rule covers enforcement, prohibited practices and other significant areas relevant to the disclosure process, including electronic disclosure, disclosure triggers and updating requirements, all subjects the UFOC Guidelines do not address.\(^\text{13}\)

As for source of authority, the revised Rule, when adopted, will have the force of law. Section 5 of the FTC Act vests the FTC with authority both to make rules prohibiting unfair and deceptive practices and to enforce them. The revised Rule embodies the federal agency’s authority over franchise sales practices.\(^\text{14}\) By contrast, the UFOC Guidelines are merely recommendations to the states for adopting a comprehensive presale disclosure scheme. The Guidelines are permissive in the sense that under both state law and (former) FTC Rule interpretation, franchisors could choose to use the UFOC disclosure format in lieu of alternative standards for preparing franchise disclosure documents found in the FTC Rule or adopted by a particular state.\(^\text{15}\)

The UFOC Guidelines are authored by NASAA’s Franchise Project Group, an arm of an independent association of state franchise regulators who work together to draft uniform franchise sales rules for member states to adopt.\(^\text{16}\) NASAA is not itself a government body and lacks control over what member states do with its recommendations. Member states may reject NASAA’s recommendations, adopt all or part, or modify or add to them depending on each state’s local concerns and politics. While member states may informally coordinate on developing consistent approaches to compliance enforcement, they do so without government mandate or supervision.\(^\text{17}\)

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\(^\text{12}\) “UFOC Guidelines” refer to the 1993 version of the UFOC’s complete disclosure Requirements, Guidelines, sample answers, and interpretive guide. See, Note 5, *supra*.

\(^\text{13}\) The registration states address many of these issues through their separate franchise sales laws.

\(^\text{14}\) See proposed Section 436.2(d)

\(^\text{15}\) Recognizing that franchisors rarely chose an alternative disclosure format to the UFOC Guidelines, the Staff Report endorses the UFOC Guidelines with the modifications outlined in this section.

\(^\text{16}\) See Notes 4 and 5, *supra*.

\(^\text{17}\) At the same time, states do not need FTC permission to establish requirements that go beyond the FTC Rule, such as registration requirements or enhanced or additional disclosure mandates. Even after the revised Rule is finalized, NASAA could recommend various UFOC Guideline enhancements to provide additional protection to investors. To
The following summarizes the key differences between the Staff Report’s proposal for mandatory disclosure document content and the 1993 version of the UFOC Guidelines:

**The revised Rule modifies, or eliminates, the following provisions of the 1993 UFOC Guidelines:**

1. The revised Rule dispenses with the mandatory "risk factors" disclosure required by the UFOC Guidelines on the state cover page.

2. The revised Rule eliminates broker disclosures (UFOC Item 2).

3. Confidential settlement disclosures would be modified (Item 3). Also exempt from disclosure are confidential settlements entered into before the franchisor started selling franchises or using the UFOC format.

4. The revised Rule simplifies computer system disclosures (Item 11).

5. The revised Rule excludes unit cost and expense information from the definition of “financial performance” thereby permitting expense information to be given to prospective franchisees without a formal Item 19 disclosure (Item 19).

6. The Item 20 charts are replaced with 5 new tables designed to prevent double-counting of single units with multiple-event histories (Item 20).

7. Franchisors with no prior audit history would not need to prepare a first-year audit. The revised Rule would continue to allow franchisors to phase-in audited financials over three years (Item 21).

**The revised Rule adds on to, or enhances, the UFOC Guidelines in the following areas, thereby creating what many refer to as the “UFOC Plus” federal disclosure document:**

1. The revised Rule significantly expands parent company disclosures, a subject not specifically addressed by the UFOC Guidelines (except with respect to parent company guarantees of franchise performance by the franchisor). The following new disclosures represent areas where the Rule would mandate broader disclosures about parents than the UFOC Guidelines:

   - Item 1: Franchisors must identify all parents, including intermediary parents.

   - Item 2: While franchisors need not disclose all parent officers, they must disclose executives in any parent organization who exercise management responsibility over franchise sales or operations.

   - Item 3: Franchisors must disclose parent litigation if the parent guarantees the franchisor’s performance.

The extent states adopt NASAA’s UFOC enhancements, we could end up with a longer list of differences between the UFOC Guidelines and the revised Rule.
Item 4: Franchisors must disclose the bankruptcy history of all parents, including intermediary parents.

2. The revised Rule adds a new category of Item 6 disclosures, fees payable to third parties. This particular addition to Item 6 has no counterpart in the UFOC Guidelines.

3. The revised Rule expands the UFOC Guidelines in a number of areas based on the FTC’s law enforcement experience by adding disclosures that reflect on the quality of the franchisor-franchisee relationship:

- Items 1 and 8: Franchisors must disclose certain potential conflicts of interest. In Item 1, they would have to disclose any competitor in which a franchise officer holds an interest. In Item 8, they would have to disclose if any officer of the franchisor owns an interest in any required supplier.

- Item 3: Franchisors must disclose material actions that they file against franchisees in the past fiscal year. Franchisors need provide only basic summary information and may group similar matters under a single heading.

- Item 3: Franchisors must disclose government litigation involving any affiliate that has offered or sold franchises in any line of business within the last 10 years whether or not the franchise used the franchisor’s principal trademark.

- Item 12: The revised Rule would expand UFOC disclosures about franchisor and franchisee rights to use other channels of distribution.

- Item 17: Item 17 must explain what “renewal” means for the franchisor’s system including, if applicable, a statement that franchisees may be asked to sign a contract with different terms and conditions from their original contract.

- Item 20: Franchisors must disclose the use of confidentiality clauses during the past three fiscal years, i.e., clauses that may affect or prevent a former or current franchisee from discussing with prospects their personal experience in the franchise system.

- Item 20: Franchisors must identify all trademark specific franchisee associations that it endorses or supports as well as any independent associations that are incorporated and specifically ask to be included in the disclosure document.

- Item 20: Franchisors must disclose to a prospect buying a specific company-owned unit the three-year turnover history of that unit detailing the previous owners, dates of operation, and reasons for each ownership change.

4. Subfranchisor financial statements (Item 21). The revised Rule would require franchisors to disclose financial statements for all of its subfranchisors that have post-sale obligations to franchisees in offerings involving that subfranchisor. This differs from the UFOC
Guidelines approach, which requires subfranchisor financial statements only when the subfranchisor is the applicant for franchise registration.

5. GAAP-Equivalents (Item 21): The revised Rule relaxes accounting standards followed by both the Rule and UFOC Guidelines for the non-U.S. franchisor's audited financial statements (i.e., U.S. GAAP) and would allow financial statements of non-U.S. franchisors to be prepared using foreign accounting standards that are equivalent, and reconciled, to U.S. GAAP. The FTC adopts the SEC’s flexible attitude towards equivalent foreign accounting standards.

6. Guarantees (Item 21): The revised Rule would require franchisors to disclose a copy of any guarantee of the franchisor’s post-sale obligations for the benefit of a franchisee. The UFOC is not clear on the need to disclose the actual guarantee document.

III. WHAT DIDN’T CHANGE

A. Overview

Several areas of franchise disclosure practice that had been candidates for revision at various points during the Rule review didn’t make the final cut into the Staff Report, and will remain unaltered from current practice if the Staff Report is adopted as submitted. These include:

- Disclosure of actual financial performance of franchises with "track records" of financial results of operations to disclose;
- Absence of private remedies for violation of the Rule;
- Franchise relationship/unfair practices regulation (for the most part);
- Prescribed disclosures in multibrand franchise offers; and
- International sales by U.S. franchisors.

B. Financial Performance Disclosure

From the beginning of the UFOC Guidelines in 1974, and until the UFOC revisions in 1993, franchise disclosure regulations had been hostile towards representations by franchisors of either actual historic, or hypothetical projected, financial results of operation of franchised business. This was an outgrowth of one of the key drivers of the enactment of franchise disclosure requirements in the first place, the widespread use during the 1960s of so-called "earnings claims" that at best were unsubstantiated and at worst intentional fabrications that were false and misleading.

Thus, the very first version of the UFOC in 1974 did not overtly prohibit "earnings claims," but it intentionally made the disclosure of financial performance information voluntary with the franchisor, and then raised the compliance standards so high for making a UFOC-compliant earnings claim that very few franchisors elected to do so.

In the period between 1974 and 1993 it became widely acknowledged that the aggressive regulation of financial performance disclosures had not so much eradicated them as driven them underground.
In order to enhance accountability for these disclosures, in 1993 NASAA, with FTC acquiescence, inverted the UFOC Item 19 regulatory philosophy to one that made it abidingly easy to comply with the Guidelines. In effect, the 1993 revision to Item 19 said: "Say whatever you want, so long as it is in the UFOC, substantiated, and formatted properly." The proportion of registered UFOCs with voluntary earnings disclosures crept up, by some accounts to as much as 20 to 25%.

During the period of the FTC's current Rule review, NASAA explored changing Item 19 to require disclosure of reported financial results of operation once a system had accumulated a certain minimum volume of such data. The initiative was strongly opposed by representatives of franchisors, and the initiative was inconclusive.

In the FTC's Rule review, comments from persons representing franchisee interests strongly supported changing the Rule to require disclosure of financial results once such data became available. Franchisor advocates again vigorously opposed it. The FTC Staff Report elects to recommend no change in the long-standing voluntary disclosure regime for financial performance information.

C. Remedies

The Staff Report also proposes to expand slightly the range of persons potentially personally liable for Rule violations, but to make no substantive change in the existing Rule relating to private remedies. The Staff Report clarifies that personal liability for Rule violations attaches to franchise sellers (including employees and third-party brokers) "... if they either directly participated in the document's creation or had authority to control it."\(^{18}\) This language certainly opens the possibility for future claims against all who participate in the creation of a UFOC as well as corporate executives and staff who contribute to it, but this exposure was at least implicit under the original Rule.

The Staff Report does not expressly address the issue that no private remedy exists, under federal law, for violation of the Rule.\(^{19}\) The federal jurisprudence is clear, and consistent, that no private cause of action exists for violation of an FTC rule promulgated under authority of Section 5 of the Federal Trade Commission Act. The Staff Report does not try to change this principle.

D. Relationship Regulation

Another area that the FTC has consistently avoided is "relationship regulation."\(^{20}\) The Staff Report deflects "relationship regulation" to the states because of a perceived lack of statutory authority to regulate "... post-sale franchise relationship issues."\(^{21}\) The Staff Report

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\(^{18}\) Staff Report at 85-86. See, Parts IV.A.4 and IV.B.4, infra.

\(^{19}\) Private remedies for Rule violations may exist indirectly under a state "Little FCT Act" or other state law for conduct that violates the state law because it amounts to a violation of a federal rule. See, e.g., Morgan v. Air Brook Limousine, Inc., 510 A2d 1197 (NJ Super Ct. Law Div. 1986); Bus. Franchise Guide (CCH) ¶ 8560 (Failure to accord a franchisee the basic minimum protection afforded by the FTC franchise disclosure rule is a per se unconscionable commercial practice under the New Jersey Little FTC Act).

\(^{20}\) Staff Report at 7-9.

\(^{21}\) Staff Report at 9.
asserts that presale disclosure is sufficient to enable prospective franchisees to "... avoid harm resulting from a franchisor enforcing the terms of the franchise agreement."\textsuperscript{22}

E. International

The Staff Report also clarifies that the Rule is meant to apply only to franchise sales occurring within the U.S., for businesses to be operated in the U.S., not to international sales outside the U.S.\textsuperscript{23}, even for sales transactions occurring within the U.S. for a franchise intended to be established outside the U.S. This is a clarification, not a change, to the original Rule.

F. Multi-branding

One last area where the Rule review had proposed the possibility of significant change, which was not included in the Staff Report's final recommendations, is in offerings of multibrand franchises. A multibrand franchise is one where a franchisee combines two separate franchised concepts in a single retail facility (e.g. a Baskin-Robbins plus Dunkin'Donuts, or a KFC plus Taco Bell).\textsuperscript{24}

The FTC's original Advance Notice of Proposed Rulemaking alluded to the uncertainty in many co-branded franchise transactions over whether the franchisee "... is purchasing two individually trademarked franchises (and thus should receive separate disclosures from each franchisor) or is purchasing a hybrid franchise arrangement that has its own risks (and thus should receive a single unified disclosure document)." It is reasonable to question whether a single franchisee acquiring two franchises to be paired in a single facility should receive separate, uncoordinated, disclosures from two franchisors with no corporate relationship other than the brand-pairing program. For example, the initial investment cost obligations disclosed in Item 7 of a single-brand UFOC in many cases represent the costs of developing single-brand facilities in each of the constituent systems, rather than the distinctive initial investment costs of developing each brand in conjunction with the other at a single location. Item 20 statistical disclosures would be another area where separate disclosure in the context of a co-brand franchise offering for both of the component brands and the co-brand combination might be appropriate.

In the end, the Staff Report simply backs away from this as a separate disclosure issue, leaving prospective franchisees to cobble together whatever understandings they can glean from the separate UFOCs of the participating franchisors, in offerings where the participating franchisors have not created a UFOC for the multibrand offering.

IV. IMPLICATIONS OF THE STAFF REPORT

The Rule changes proposed in the Staff Report raise an array of implications, for prospective franchisees, franchisors, franchisor attorneys, and NASAA as custodian of the UFOC Guidelines. This section explores the key implications to prospective franchisees (Part A), franchisors (Part B), franchisor attorneys (Part C), and NASAA and the UFOC (Part D).

\textsuperscript{22} Staff Report at 10.
\textsuperscript{23} Staff Report at 72-75.
A. Implications for Franchisees

The Rule exists in the first place to protect prospective investors in franchises by mandating pre-commitment disclosure of prescribed categories of information. Based on the ongoing volume of reported litigation relating to franchise disclosure compliance, and the steady stream of investor complaints lodged with the FTC and state franchise administrators, its achievement of that goal in the years following promulgation in 1979 has been decidedly mixed, and the implications of the Staff Report for prospective franchisees also is mixed. Some elements of the Staff Report will be a definite improvements for prospective investors, while others will be less helpful. It seems likely that the changes proposed by the Staff Report in the aggregate will be beneficial to prospective investors by facilitating early access to UFOCs through digital channels of distribution, and by making the changes in content that the Staff Report proposes. Removing the "first personal meeting" disclosure trigger, and the cover page risk factors, however, may diminish the likelihood of investor scrutiny of a UFOC early in the due diligence process. We will consider our "top 12" list, in numerical order, as they relate to prospective franchisees.

1. **Cover Page**

*Implications: neutral.* The Staff Report would streamline the federal cover page by eliminating "risk factors" disclosure and some boilerplate, add what amounts to cross-references to other sources of information, and offer flexible modes of delivery. These changes will likely facilitate understanding what the UFOC is and how to get one, but the benefit of these improvements to prospective investors is modest, and possibly are offset in part by removal of the attention-focusing "risk factors" statements.

2. **Electronic Disclosures**

*Implication: favorable.* We live in a digital age, in which the old UFOC rules for 12-point type and paper delivery at personal meetings seem almost quaint. Thus, the Staff Report's embrace of flexible modes of delivery of the prescribed "content" is not just trendy, it actually aligns the disclosure process with the ways in which research is conducted and business is transacted at the beginning of the 21st Century.

In the NASAA electronic delivery guidelines, it may fairly be implied that posting disclosure on the franchisor’s website or anywhere else on the internet would be acceptable. The revised Rule would explicitly allow for this. Website posting will make it easier for prospective franchisees to access the disclosure at a time of their choosing as well as permit easier updating for the franchisor. The electronic delivery requirements also explicitly disallow any distracting items such as pop-up advertising. The revised Rule will also require that the delivery of media, a password, or the announcement that the disclosure document is available on a website be accompanied by instructions on how to access the disclosure document as well as what software and hardware requirements would be necessary to read and print the document. By closely following NASAA's electronic disclosure protocols, the Staff Report adopts principles that were carefully and methodically developed by the state administrators and industry experts.

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25 *Revised Rule,* § 436.2(c)(2).

26 *Revised Rule* at § 436.6(c).
Allowing for electronic disclosure will make it easier for both the franchisee and franchisor to be able to access and use the disclosure documents. The revised Rule also makes the disclosure process easier for the prospective franchisee by allowing the franchisee to choose to have the disclosure delivered to a representative, such as an attorney or accountant. The updates to the timing requirements give prospective franchisees an opportunity to review the disclosure documents at a point in the sales process of their choosing as well as give them a substantial period to review and digest the disclosure information. This change should help more prospective investors have easier access to more pre-commitment information and therefore is clearly a favorable change.

3. Exemptions

Implication: negative. One does not protect the interests of prospective investors by allowing franchisors to withhold from defined categories of prospective franchisees investment information available in the UFOC. Yet this is the effect of the Staff Report’s proposal to exempt sales of moderately expensive franchises (where initial investments other than real estate exceed $1 million) or sales to well-heeled investors (with five years of business experience and a defined net worth of $5 million). Many garden-variety restaurant franchises exceed a million dollars in development costs, especially in multiple-unit deals. The Staff Report reasons that experienced investors (with the defined level of business experience and net worth) can demand UFOC-quality information from franchisors.27 One can be skeptical that a franchisor trying to avoid the cost and delay of developing a UFOC by relying on this exemption is likely to turn around and willingly proffer substantially the same information on request by a single prospective franchisee, even a well-heeled one.

The value of this exemption even to franchisors is not clear. It seems unlikely that many ordinary business-format franchisors would limit their development program to non-registration states and either large-scale investments or wealthy investors in order to qualify for this exemption and avoid the cost of preparing a UFOC, which would be an almost trivial part of the franchisor’s own total administrative and program development costs. And if any prospective deal or candidate investors were to fall below the exemption’s dollar thresholds, or if any prospective investor should reside in a registration state (or any presale meetings occur in a registration state, or presale "offering" communications are directed into a registration state), a UFOC will be necessary anyway.

This exemption may prove to be of value predominantly as a sort of surrogate for an isolated sale exemption in non-registration states, and to franchisors of only very large-scale businesses such as hotels and large grocery stores. But, their prospective franchisees will then be deprived of ready access to UFOC information, driving up their costs and risks.

The other new exemption is for sales to franchisor insiders (e.g., retiring franchisor executives) who meet common-sense experience qualifications. This should prove to be of little or no significance to most prospective franchisees.

4. Personal Liability for Sellers

27 Staff Report at 238.
Implication: slightly favorable. The Staff Report proposes to clarify the personal responsibility for Rule compliance of the franchisor staff who prepare or contribute to UFOC preparation, or who might violate the unfair practices provisions of the revised Rule.

This change will enhance the FTC's enforcement power in the exceedingly rare cases where it actually enforces the Rule, and, through what will likely be a new wave of CLE presentations and article expositions, enhance franchisor staff's (and counsel's) awareness of the Rule and the wisdom of trying very hard to comply with it.

Whether the real-world impact on prospective franchisees rises above the level of the merely theoretical remains to be seen.

5. Franchisor-initiated Litigation

Implication: strongly favorable. Heretofore, most franchisors have read UFOC Item 3 not to require disclosure of litigation that they initiated against their own franchisees. This created a loophole of sorts in systems where the franchisor or its affiliates (e.g., finance companies, or product vendors) had a pattern of suing franchisees. The revised Rule will compel disclosure of these cases on a rolling, trailing year, basis.

Where such litigations exist, prospective new-entrant franchisees should be forewarned, and the Staff Report effectively and efficiently does so.

6. Parent Disclosure

Implication: favorable. UFOC Item 1 has not always brought about effective disclosure of who ultimately owns or controls the franchisor. The Staff Report fixes that by compelling "parent" disclosure in a number of areas where a prospective investor would want to know parallel information concerning both the franchisor entity itself and its parent, or controlling, organization(s).

These disclosures will be useful to prospective franchisees in cases where the franchisor is controlled by another organization or person with a negative business experience, or which competes against franchisees of the particular system, or which is a major vendor to what is presented as a business format franchise, or is part of a broader conglomerate enterprise.

While it is true that many franchisors volunteer much of this information already, the Rule revisions will level the playing field by compelling all affected franchisors to provide comparable information.

7. Financial Performance

Implication: mixed. The Staff Report proposes modifications to Item 19 that will be quite positive for prospective franchisees, as far as they go, but the failure to compel disclosure of financial performance where such data exists leaves untouched the existing Item 19 loophole of voluntary disclosure, which allows franchisors of franchise programs with histories of poor results or financial failures to withhold and conceal the negative financial results.

The positive changes include reversing an ill-considered change in the 1993 revisions to Item 19 that swept into the definition of "earnings claims" mere cost information. Previously, under the UFOC Guidelines, earnings claims had consisted only of quantified revenue-oriented
information: sales, income, return on investment, unit volume, etc. Cost information alone, even expressed as a percentage of sales (e.g., "your labor costs should not exceed 30% of sales"), was not covered. (Indeed, what are UFOC Items 5, 6, and parts of 7, if not compilations of franchisees' costs?)

This aspect of the 1993 change was unnecessary and counterproductive. The Staff Report eliminates it.

The Staff Report will also eliminate (or at least suppress) a nefarious practice by some ignorant or unscrupulous franchisors who tell prospective franchisees that they do not provide financial performance information not because they choose not to, but because "the government won't allow us to" or "the law prohibits it." New mandatory disclosures in the text of Item 19 will make clear what the rules are about financial performance disclosure, and should put a halt to falsely exculpatory statements by franchisors who choose not to offer financial performance information for whatever reason.

The familiar and beneficial exclusions from Item 19 for disclosure of the records of a particular franchisor-owned unit offered for sale to a franchisee, and for supplemental disclosure to prospective investors in a particular location if (and only if) financial performance data is disclosed in the UFOC, are preserved.

8. Franchisee Associations

Implication: strongly favorable. The Staff Report proposes adding an entirely new category of disclosure: franchisee associations specific to the franchise system. This includes organizations created, sponsored or endorsed by the franchisor, as well as autonomous associations that request (on an annual basis) inclusion in the UFOC and provide minimal contact information for the association.

This information will prove to be a significant benefit to prospective franchisees, enhancing the lists of current and past franchisees long part of the UFOC, as a source of independent information concerning the franchise system. One of the main benefits to a prospective franchisee who is unfamiliar with the system is that conversations with elected officers of an independent association of franchisees is likely to elicit highly valuable insights into the tenor of franchisor-franchisee relations in the system. Do franchisees have a meaningful participation in system decision-making? Does the franchisor act cooperatively in approving transfers, renewals, and requests for approval of independent, competitive sources of supply? Are the franchisor's training and other support services valuable? Do franchisees have a voice in system advertising? Or, is the franchisor dictatorial, adversarial, or distracted by other business ventures? This kind of information usually is not readily available in the UFOC, or on a comprehensive basis from individual existing franchisees.

These required disclosures may have the unintended but entirely salutary effect of improving the communication, cooperation and overall relationship between some independent franchisee associations and the franchisor of the system in which they operate. Hopefully, hostile reactions of some franchisors to independent franchisee associations will become a thing of the past.28

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28 For a summary of the outcomes of cases involving discriminatory and retaliatory conduct of franchisors against franchisee association members and leaders, see Mark J. Burzych, Eric H. Karp and Karen Boring Satterlee, Discriminatory Treatment of Franchisees, 27th Annual Forum on Franchising, W-11 (ABA 2004).
9. System Statistics

Implication: strongly favorable. UFOC Item 20 has become a confusing and internally inconsistent jumble of statistical data concerning the size, shape, and trend of the franchise system. The Staff Report takes an entirely fresh approach to displaying this data. The Staff Report and revised Rule eliminate the double counting of outlets that was possible under the UFOC Guidelines. The double counting is eliminated with a specific mandate of format and instructions as to how each outlet should and should not be counted in the various categories. Eliminating the double counting should give franchisees a clearer picture of the national strength of the franchise, the number of transferred outlets, turnover of both company and franchisee-owned outlets, and the rate of growth that the franchisor expects. The new Item 20 will be much more clear and useful to prospective franchisees.

10. Confidentiality and Integration Clauses

Implication: strongly favorable. Some franchisors have tried to impede or circumvent the effectiveness of presale disclosure in two ways.

First, the UFOC requires a list of current and recently separated franchisees for the specific purpose of enabling prospective investors to contact them to ask about their experience with the franchise. Nothing obligates the current or past franchisee to speak with the prospect, but most will do so voluntarily. If the franchisor extracts confidentiality commitments from departing franchisees (e.g., as a condition to consenting to a transfer, or to settle a termination dispute), that franchisee may be legally precluded from discussing the franchise with the prospect. The Staff Report would require disclosure concerning such clauses, alerting prospects to the obstruction to their due diligence efforts, and perhaps raising questions in the mind of the prospective franchisee about the character of franchise relations in that system.

The second device that some franchisors have used to try to insulate themselves from responsibility for their own disclosure documents is the customary broad-form integration clause used in many franchise agreements. These clauses purport to exclude from consideration in a future dispute anything – representations, negotiations, etc. – outside the four corners of the final, written franchise agreement. Some franchisors carve out from this clause and thereby preserve their UFOC, others do not. Some franchisors have used their unqualified integration clauses to try to exclude their own UFOC disclosures and representations from consideration in subsequent disputes. The revised Rule would prohibit such use of integration clauses. This obviously will be quite favorable for franchisees, as it will reconfirm their right to rely upon the disclosures in the UFOC.\(^{29}\)

11. Updating UFOCs

Implication: neutral. The changes recommended in the Staff Report likely will not materially alter disclosure practice: the changes (i) reinforce franchisors' obligation to disclose

\(^{29}\) See, TCBY Systems, Inc. v. RSP Co., 33 F.3d 925, 929 (8th Cir. 1994) (finding that it is proper to look to a franchisor's brochure as evidence of the meaning of the site selection provision of the parties' Franchise Agreement); Brennan v. Carvel Corp., 929 F.2d 801 (1st Cir. 1991) (finding that it is proper to look at a franchisor's disclosure statement in determining the intent of the agreement); Chicago Premium Yogurt, Inc. v. Yogurt Ventures, U.S.A., Inc., No. 91 C 0209, 1992 WL 3705 at *2 (N.D. Ill. Jan. 2, 1992) (UFOC properly considered in assessing whether failure to approve assignment of franchise was a breach of the Franchise Agreement); Peterson v. Mister Donut of Am., Inc., No. 87-3205 (AET), 1988 WL 71734 (D.N.J. July 6, 1988); Thompson v. Atlantic Richfield Co., 663, F. Supp. 206, 209-10 (W.D. Wash. 1986).
material information beyond the literal requirements of the Rule (and UFOC Guidelines), in a sort of "10b-5" analog: a duty to disclose additional information necessary to make the required disclosures not misleading; and (ii) revise and clarify annual and quarterly updating requirements. UFOCs registered in a registration state will continue to be subject to much more demanding state updating requirements. We expect these changes will enhance the disclosures offered in UFOCs used in the non-registration states, but the incremental benefit to prospective franchisees will be slight, absent a vigorous and sustained federal enforcement campaign based on the "material information" standard.

12. Preemption

Implication: favorable. The statement of preemptive effect does not materially alter the existing Rule. The Rule establishes minimum standards of disclosure. States may add requirements that "are not inconsistent." Thus, registration requirements, impound order authority, and additional disclosure categories would not be preempted. States do not need FTC permission or acquiescence in order to establish disclosure or relationship regulations that go beyond the Rule requirements.

Some ambiguity remains relating to state (i.e., NASAA's UFOC Guidelines) disclosure requirements that do not necessarily go above and beyond the Rule requirements but are merely different. Whether such disclosures are "inconsistent" is not always self-evident. May the registration states, either independently or through NASAA action to modify the UFOC Guidelines, modify the disclosure format of otherwise Rule-compliant disclosure documents to match the traditional UFOC "Items"? May they require disclosure of franchisor-initiated litigation going back three years rather than one? May states mandate financial performance disclosure in Item 19?

B. Implications for Franchisors

From a franchisor's perspective, the overall goal of the revisions should be to make the current Rule both more effective and to balance the franchisor's burdens and expense of disclosure with the prospective franchisee's benefits from receiving the disclosure, along with enhancing the orderly function of capital markets through the disclosure process. From the comments by franchisors to the ANPR, NPR and Staff Report, most franchisors appear supportive of the efforts of the FTC in revising the Rule and the overall direction of the proposed revisions. Those objectives are not always complementary. Some efforts to make the Rule more effective will increase disclosure compliance burdens for franchisors, and efforts to lessen the disclosure burdens on franchisors may make the disclosure less effective for franchisees. Franchisors strongly urged that additional compliance burdens be imposed only to the extent that they materially aid prospective franchisees overcome the informational imbalance between franchisors and franchisees, which has been a stated objective of the Rule since its inception.

The Staff Report proposes scores of changes to the current Rule, the vast majority of which are neutral to franchisors and relate to the adoption of a disclosure format that is based on, and similar to, that required under the Uniform Franchise Offering Circular Guidelines. This section will focus on the impact of some of those significant changes identified in Part II of this paper that will either affect existing franchisor obligations, impose different obligations or alter franchisor conduct.

1. Cover Page
Implication: neutral. The Staff Report proposes removing the mandatory risk factors from the cover page – but that does not prohibit states from requiring them or a separate risk factor page. New required references to the FTC website and information guide may be useful to prospective franchisees and are not unduly burdensome to franchisors.

2. Electronic Disclosure

Implication: strongly favorable. Electronic disclosure will be a huge benefit to franchisors and prospective franchisees and have a profound effect on how information is delivered. The larger the franchise system in terms of the number of units, the larger the benefit will be. The benefit will be substantial in terms of costs, manpower and ease of administering a franchise system.

While there is no obligation to re-disclose to existing franchisees, a substantial part of the growth of most systems (particularly the larger systems) is through the development of additional units by existing franchisees. Many small franchise systems re-disclose all of their existing franchisees every year when their updated offering circular or an amendment is issued to keep them appraised of changes in the system and for prophylactic purposes with respect to ongoing discussions related to new unit growth. As systems get larger, the costs to re-disclose the entire system by paper becomes entirely cost prohibitive. Therefore, larger systems typically only re-disclose those prospective franchisees that have active new development deals or are prospective franchisees in connection with a transfer.

Franchisors will be able to make the disclosure document available on its franchisee (or other) website and notify all of its franchisees by email that it is available. Franchisees then have the ability to download the circular. Entire systems can be re-disclosed timely and efficiently, at a cost acceptable to most franchisors.

Before a first personal meeting (or closing a transaction, under the Proposed Rule), a paralegal or contract administrator would need to confirm in advance that an electronic receipt is on file. If no receipt was on file, the prospective franchisee would either have to download the document again, or be provided the document through other means, and a receipt obtained. Franchisors may chose not to make their offering circulars available on their website to the general public, and may limit access or delivery to only pre-qualified prospects.

The Proposed Rule requires that all disclosures provided electronically be capable of being stored, downloaded, printed, or otherwise maintained, so that prospective franchisees can retain a copy, as well as show a copy to their advisors. This would be the functional equivalent of delivering a hard copy to a franchisee. The Staff Report drops its earlier proposal that franchisors using electronic media be required to provide prospective franchisees with a paper summary document containing an expanded cover page, table of contents, and acknowledgment of receipt. Electronic disclosure may be limited in registration states that do not approve electronic disclosure, but the delivery mechanism and availability of information in the franchise community will be substantially enhanced by this proposal.

3. Exemptions and Exclusions.

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30 Staff Report at 86.

31 Staff Report at 90 to 91.
The changes that will result in the greatest impact on a franchisor’s disclosure obligations and conduct are those that create new exemptions and exclusions from the coverage of the Rule and its disclosure requirements.

a. **International Transactions**

*Implication: strongly favorable.* The recommendation in the Staff Report that the Rule only apply to offers for franchise locations to be established in the United States was strongly supported by franchisors. This new proposed Section 436.2 creates a clear, "bright-line" exclusion for all franchise transactions involving businesses to be operated outside of the states of the United States. Franchisors offering franchises for businesses to be established and operated outside of the United States have debated the application of the FTC Rule to such transactions for years. Franchisors currently take a variety of approaches to such transactions. Some franchisors prepare and utilize in all transactions complete offering circulars based on the UFOC guidelines describing their international offerings in broad terms with a variety of disclaimers so that the document can be used in a variety of jurisdictions. Others conduct a complex analysis of the nexus of the transaction to the United States to determine whether the Rule applies to the transaction. This is particularly the case in what some have termed a mixed outbound transaction, where U.S.-based investors are involved in a transaction for a business to be operated outside of the United States. This analysis includes questions such as: Is the franchisee a U.S. entity or a foreign entity? Where is the principal place of business? Are the U.S. investors controlling? Is the franchisor requiring a guaranty by the U.S. investors?. The Proposed Rule would eliminate the need for this analysis and obligation to provide disclosure, and potential liability for failing to comply, despite commercially reasonable efforts to do so.

This exemption does not, however, mean that franchisors will not provide disclosure to prospective franchisees in some form or another (or in some transactions, be obligated to do so). Some non-U.S. jurisdictions have their own franchise disclosure laws with which franchisors must comply, although, typically, the disclosure required is less cumbersome and comprehensive than under the Rule. In addition, a number of civil code jurisdictions, while they may not have a franchise specific disclosure law, require disclosure of certain material facts regarding the proposed transaction. There also may be non-U.S. sales with sufficient nexus to a particular U.S. registration state where no exemption is available and disclosure is required. As a practical matter, franchisees and the marketplace will dictate that franchisors provide prospective franchisees with certain information concerning the transaction necessary to make their investment decision, such as the fees the franchisor charges, investment costs for items purchased through the franchisor or its affiliates (which the franchisor can provide with reasonable certainty), and descriptions of the training and services provided to the franchisee, among other things. The result of the exclusion may be that franchisors are more inclined to provide, and franchisees receive, more relevant commercial information in a shorter, digestible format then under the current disclosure regime.

b. **Sophisticated Investor Exemptions**

*Implication: strongly favorable.* In the NPR and Staff Report, three new exemptions were proposed that turn on the status and sophistication of the investor. The proposed Section 436.8(a)(5) contains a Large Investment Exemption and a Large Franchisee Exemption. The third exemption, Section 436.8(a)(6), involves the sale to officers, directors, partners and

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32 Staff Report at 72.
individuals with management responsibility for the offer and sale of franchises or administration of the franchised network. The latter is of limited utility to franchisors with established programs. Simply put, if the franchisor has a disclosure document, rather than rely on the exemption, regardless of whether the prospect is an insider and does not need the information, it will likely deliver the document. The exemption will provide an opportunity to sell to insiders when no offering circular is available, and for sales to insiders on terms that differ from the standard offering. Where the company has not developed a franchise program, or does not plan to do so, the exemption will permit it to sell a limited number (under the defined conditions) to test the opportunity. Currently, companies in that position struggle with compliance by (1) structuring arrangements to avoid the franchise laws, such as partnerships or joint ventures; (2) incurring the expense of preparing disclosure documents for programs that ultimately never get off the ground or are offered to only a few people; or (3) run the risk of noncompliance.

The two exemptions contained in Section 436.8(a)(5) may ultimately have broad reaching implications with respect to certain types of qualifying transactions. Section 436.8(a)(5)(i) of the Proposed Rule exempts the offer and sale of franchises where the initial investment exceeds one million dollars, exclusive of any financing received from the franchisor or its affiliates, and the prospective franchisee signs an acknowledgment verifying compliance with the exemption. The Staff Report concludes that a bright line test based on the amount of the investment would provide the most utility in terms of implementation, rather than a test that would require an analysis on a case-by-case basis of the relative sophistication of the franchisee. Had it stopped there, the exemption would have been clearly available to an entire class of franchise offerings such as hotels, large casual dining restaurant chains and multi-unit offerings where the initial investment exceeds that amount, and be of significant benefit to certain franchisors.

But the Staff Report went on to say that the Staff perceived a difference between a group of 10 investors each investing $100,000 and a transaction where one investor invested the entire amount, and the Staff proposed that the exemption apply only “if at least one individual in the investor group “qualifies” as sophisticated by investing at the threshold level.” If this last element is imposed in the final Rule, the utility the exemption will become fairly limited. This line appears to be inconsistent with the rest of the discussion of the term “investment” where the Staff focused on the amount of the initial investment set forth in UFOC Item 7, such as building and other infrastructure costs, including, in connection with conversions and re-sales. Typically, however, most of those costs will be financed.

For example, in the context of a typical limited service hotel where the initial investment, exclusive of real estate, may be $6 to $8 million, the project usually will be seventy to seventy-five percent leveraged. It is unlikely that any one individual in any of these transactions will personally invest $1 million or more in equity. If the project is being put together by individual investors, typically, two or more principal investors will each invest several hundred thousand dollars, along with some lesser investors (but it is important to remember that these investors collectively are sophisticated enough to pull together $1.5 to $2 million in equity and another $4.5 to $6 million in debt financing – using other persons’ capital to reduce the risk of their investment; hire counsel capable of pulling together all of the related documents necessary to

33 Staff Report at 249.
34 Staff Report at 237.
35 Staff Report at 242.
document the deal, obtain zoning approvals, easements and other governmental approvals necessary to develop the project; engage architects and construction companies to design and construct the project; and to operate the franchised business). There may be a significant number of transactions with corporate investors putting in the entire amount, but oftentimes even those entities that are putting together the deal will bring in equity partners to spread the risk, reducing their individual equity investment below the threshold level.

If the single-investor rule is applied to the exemption, as a practical matter, franchisors in some sectors likely will have to prepare disclosure documents in accordance with the Rule because enough of their prospective franchisees will consist of groups of investors, no one of whom will meet the conditions of the exemptions, that programmatic offerings will not be possible under the exemption. The franchisor will need to conduct an analysis of each individual project to determine if the project qualifies for the exemption based on the individual franchisee’s financing structure, which will require a significant amount of due diligence on the part of the franchisor and result in a significant number of projects that may not qualify.

The utility of the exemption, even if it is given the broadest interpretation, will be limited at least to some degree by the lack of a similar exemption in most registration states. Those states that have an exemption based on the amount of the investment, typically exempt the transaction from the registration process, but do not exempt the franchisor from its obligation to deliver an offering circular. Therefore, if a franchisor has an obligation to prepare and provide disclosure documents in major markets in which it is currently offering, it is likely that the franchisor will continue to prepare an offering document and deliver it to all prospective franchisees, as it would be awkward from a business and franchise relationship perspective to deliver a prospective franchisee an offering circular in Illinois and Indiana, but not provide one to a prospective franchisee in Ohio. That said, franchisors that qualify for the exemption, even if they continue to prepare and deliver disclosure documents, would perceive it to be a significant benefit to have no liability for technical disclosure or timing violations in thirty-eight non-registration states. It also will eliminate concerns of the accidental franchise in a number of licensing arrangements involving substantial investments in those jurisdictions.

Some franchisors may elect not to provide disclosure when it is not legally mandated. But, given prospective investors’ desire for information particularly those sophisticated enough to qualify for the exemption, it is hard to imagine that a franchisor would not be required by the demands of such investors to prepare and provide sufficient information concerning the commercial aspects of the transaction for the prospective franchisee to make an informed investment decision.

Proposed Section 436.8(a)(5)(ii), the Large Franchisee Exemption, will exempt from the coverage of the Rule transactions with prospective franchisees that have been in business for at least five years and have a net worth of at least five million dollars. This exemption will provide an opportunity for similarly situated entities (well capitalized franchisors and franchisees) to conduct business on a purely commercial basis without the overlay of the regulatory scheme. Like the other exemptions, it may not be useful foundation for an entire franchise program, as it is unlikely that all of its proposed franchisees will meet these criteria, and the same issues with respect to the registration states described above apply.

36 Staff Report at 245.
The Large Franchisee Exemption, when considered in combination with the Large Investment Exemption, collectively, even if the registration states do not follow, will exempt a significant number of transactions involving sophisticated parties from many of the more burdensome and administrative/technical provisions of the Rule (e.g., disclosure timing issues), and allow commerce among such parties to flow more freely. The franchisor will not have liability or concerns regarding technical non-compliance, and it will reduce substantially the number of situations that presently occur where the regulatory "tail" ends up wagging the commercial "dog" in complex transactions. These exemptions will not, however, eliminate a franchisor’s liability for unfair or deceptive trade practices under Section 5 of the FTC Act.

4. **Personal Liability for Sellers**

*Implication: negative.* The Staff Report proposes to impose liability for Rule compliance/violations upon an expanded number of people by defining a “franchise seller” to include any person that offers for sale, sells or arranges for the sale of a franchise, including the franchisor, its employees, representatives and agents, subfranchisors, and third-party brokers who are involved in franchise sales activities.\(^{37}\) This will also expand personal liability for Rule violations under Section 5 of the FTC Act and state little FTC Acts for such persons. A number of the comments from franchisors suggested clarifying that the definition applies only to employees, representatives and agents of the franchisor who are involved in franchise sales activities, out of concern that the wording suggested that all employees of the franchisor are personally liable even though they may not be directly involved in franchise sales. This concern was noted in the Staff Report, but left unchanged in the proposed Rule. Appropriately, under state law, persons involved in the franchise sales process who knew or should have known about the violation have always had potential personal liability. The Staff Report suggests that under the revised Rule franchise sellers would be liable for the content of a disclosure if they directly participated in the document’s creation or had authority to control it. Under that interpretation, every employee, agent or representative who contributed any information that was used in the offering circular could be potentially liable, without further clarification.

5. **Franchisor Initiated Litigation**

*Implication: slightly negative.* The changes proposed to litigation disclosure in Section 436.5(c) – Item 3 may have significant impact in the litigation disclosure in franchise systems with collection issues or system standard compliance issues. The more profound effect this change will have, however, is on the decision-making process a franchisor undertakes in determining whether or not to bring an action to enforce compliance with its franchise agreement (particularly those franchisors with little or no other, reportable franchise litigation). One clearly can see the potential materiality to a prospective franchisee of a franchisor’s proclivity to sue its franchisees. For franchise systems with significant numbers of disputes between the franchisees and franchisors, litigation is already being disclosed in the offering circular. If a franchisor has to sue a number of its franchisees on a regular basis to enforce its agreements, a number of those franchisees likely will bring counterclaims that the franchisor will have to disclose in its UFOC. Therefore, adding this disclosure to their litigation section may be of little or no consequence.

For franchisors that do not routinely sue their franchisees and have little or no litigation disclosure in their offering circular, the decision to sue or settle disputes before suing will be

\(^{37}\) Staff Report at 45.
impacted by their obligation to disclose. For example, if a franchisor has no other litigation to disclose and a franchisee owes the franchisor a modest amount on some commercial (rather than relational) account, that franchisor will think long and hard about suing to collect, not because the franchisee does not owe the money or because of the counterclaim risk, but simply because the negative disclosure ramifications to disclosing the suit might exceed the value of what it will collect from the franchisee. This provision alters the analysis of whether to sue in favor of the franchisee.

The Staff Report attempts to balance the burdens of this disclosure by limiting the disclosure to only “material” franchisor initiated litigation and to require updating only once a year. The Staff Report also suggests that the franchisor may provide a summary of these cases under a common heading, such as “royalty collection suits.” This may mitigate the impact of disclosure regarding garden variety collection actions, but then depending on the system and the size of the disputes, prospective franchisees still may not receive timely information concerning franchisors that regularly sue their franchisees and a franchisor will be at risk for not timely disclosing and updating information concerning what is by definition now “material” litigation.

6. **Parent Disclosures**

*Implication: negative.* The disclosure required under Items 1, 2, 3 and 4 of the UFOC concerning the franchisor’s parent has been expanded. For most franchisors, this requirement will have little impact. For a few, this will have significant impact, and require information not previously disclosed in the offering circular. In Item 1, this will include identifying all the entities that directly or indirectly control the franchisor. This may cause confusion in situations where multiple corporate layers exist and franchising of more than one brand is involved. In addition, the franchisor must disclose the experience of entities with common controlling ownership that are offering franchises in other businesses, as well as, those that are offering products or services to the franchisees. This latter requirement was previously covered in Items 1 and 8 of the UFOC, which required franchisors to disclose information concerning affiliate transactions (which should have included parent disclosure). Hopefully, the interpretive guides will provide guidance concerning the level of disclosure required for intermediate holding companies, and the scope of the disclosure of these relationships can be fairly limited.

The NPR also proposed requiring disclosure of the name and experience of any officers or directors of the parent who will have management responsibility relating to the franchises offered. The Staff Report instead focuses the disclosure on those persons with control of activity at the franchisor level and who occupy a similar status or perform a similar function. This could substantially broaden the number of persons subject to disclosure upstream. Item 3 litigation disclosure will apply to such persons as well.

The NPR proposed requiring disclosure of all enumerated litigation involving the parent of the franchisor. This has been tempered in the Staff Report to require only disclosure of the enumerated litigation of the parent if the parent guarantees the performance of the franchisor, and government actions against parent companies regardless of whether a guarantee is provided. Franchisors establish subsidiary relationships, and/or retain them in connection with

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38 Staff Report at 116 to 118.

39 Staff Report at 94 to 96, 99 to 101, and 103.
corporate acquisitions, for a variety of reasons; the new requirements may influence how some companies choose to structure their holdings, to re-capitalize subsidiaries, to prepare audited statements of subsidiaries, and eliminate guarantees to avoid such disclosure.

Requiring the disclosure of bankruptcy history of any parent will not be excessively burdensome to franchisors generally, as there are likely relatively few systems that have multi-tiered organizational structures, and have had a parent file bankruptcy. The information may be of limited utility to franchisees, but given the limited applicability of the requirement, it will not have a significant impact on franchising generally. There may be questions in the odd circumstance in multi-tiered organizations as to whether a particular entity is the parent based on the direct or indirect control definition, like the rest of the disclosures above.

7. Financial Performance

Implication: strongly favorable. The Staff Report proposes substantially revising the Rule to be more consistent with Item 19 of the existing UFOC Guidelines, which is a giant step forward by the FTC. Since most franchisors are already using the UFOC, those changes, however, do not materially alter the status quo. The Staff Report also proposes eliminating cost information from the definition of a “financial performance claim” and therefore will make clearer that such information contained in Items 5, 6 and 7, or elsewhere does not rise to the level of a financial performance claim. The Staff Report also improves the accuracy of the negative disclosure to be used when the franchisor does not offer a financial performance claim to clarify that the law does not prohibit the use of such claims. Franchisors generally were pleased that financial performance claims were not made mandatory for a variety of reasons, not the least of which was mandating liability for use of information that is primarily within the control of franchisees.

8. Franchisee Associations

Implication: slightly negative. The Rule will now require disclosure of pertinent information concerning trademark specific franchisee associations related to the franchise system being offered that is either created, sponsored or endorsed by the franchisor or that asks to be included in the offering circular. The obligation is limited to incorporated associations that request within 90 days after the close of the franchisor’s fiscal year to be included. Franchisors have expressed concerns regarding being required to include disclosure related to groups of franchisees that are not recognized or supported by the franchisor. The franchisor is permitted to include a disclaimer concerning the organization and its members not being representative of the system. Contact information concerning legitimate franchisee organizations that may provide a useful source for information for prospective franchisees is readily available and not a significant burden to include in the offering circular. In cases where an association is not staffed, the officers and directors of the association who are listed in the offering circular will receive the calls from prospective franchisees, and others.

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40 Staff Report at 118 to 119.

41 Staff Report at 158 to 167.

42 Staff Report at 195 to 196.
9. System Statistics

Implication: strongly favorable. The new charts and instructions for Item 20 provide greater clarity with respect to the disclosure required, and will benefit franchisors and franchisees. It will eliminate confusion as to the tracking of multiple events relating to the same unit, and how those are to be accounted for in the offering document. The requirement that the franchisor disclose certain information for the past five years for a franchised outlet that it is selling is a little odd. If the franchisor has reacquired it and is re-selling it, is it to be classified as a franchised unit or a company-owned unit that it is now re-selling? The conservative approach would be to treat it as a franchised unit if it was owned at any time during the preceding three years by a franchisee and to provide the last available information. Units are bought and resold for a variety of reasons, and while this may be a little burdensome (and particularly so for companies with over a thousand units) and require franchisors to track information not presently maintained in their database, it is information that could be tracked on a going forward basis. When the revised Rule is implemented, the interpretive guides will need to provide for a phase in of information not previously tracked, as it may require franchisors to expend significant resources attempting to obtain and/or recreate information that is not readily available.

10. Confidentiality and Integration Clauses

Implication: neutral with respect to confidentiality and very negative with regard to integration clauses. There has been debate concerning confidentiality agreements that potentially limit the ability of existing franchisees to speak freely with prospective franchisees, and, thus, limit the utility of the lists in Item 20 of existing and former franchisees. From a franchisor’s perspective, there is likely no system of any size that has not settled a dispute with a franchisee or negotiated a deal where the terms are not subject to confidentiality restrictions, so this disclosure may become no more than an unremarkable "boilerplate" sentence buried deep in Item 20.

The FTC has attempted to settle this debate in a balanced fashion by requiring that a franchisor disclose in Item 20 whether franchisees have signed confidentiality clauses in franchise, settlement or other agreements in the last three years. If so, the franchisor must include a statement advising prospective franchisees that in some instances current and former franchisees may be restricted in speaking with the prospect. Adding this to every offering circular at least will put franchisees on notice that such restrictions may exist and is minimally intrusive. A franchisor may choose to indicate the number and percentage of current and former franchisees subject to such arrangements or to include a description of circumstances surrounding such clauses. This may help explain why these clauses have been employed, and dispel any negative impression they may create.

The revised Rule makes it an unfair or deceptive practice under Section 5 of the FTC Act for a franchisor to “disclaim or require a prospective franchisee to waive reliance on any representation made in a disclosure document or in its exhibits or amendments.” The revised Rule also goes on to state that this provision is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in the disclosure document in the negotiations of a franchise sale.

43 Staff Report at 181 to 191.
Most franchisors understand and appreciate the Commission’s desire to protect individuals who have made substantial financial investments in franchises based upon representations contained in the offering circular or upon other written or oral representations that later prove to be untrue or incomplete. While most franchisors agree that a franchisor should not be able to escape its obligations under the Rule by requiring franchisees to waive or release claims in connection with the offer and sale of a franchise (as opposed to the later settlement of disputes, or agreements with respect to attempts to cure inadvertent violations), the discussion surrounding the proposed remedy contained in the Rule and the basis for changing integration clauses described in the NPR could be problematic for franchisors.

Merger and integration clauses are a time-honored tenet of common law adopted to clarify the boundaries of the agreement between the parties, and to support the parol evidence rule. Without such a rule, parties are unable to rely upon the final executed documents as the definitive manifestation of the parties’ intent. Courts seem to be able to preserve UFOC disclosures when interpreting ambiguous terms of franchise agreements or other agreements.44

Franchisors will have to either modify their integration clauses under the revised Rule or include some form of representations clause that evidences an intent not to exclude the franchisee’s reliance on the disclosures. For example, the franchisor could have a standard integration clause that states that the four corners of the document contain the entire agreement of the parties, and then a clause that states the franchisee is not relying on any representations of the franchisor in entering the agreement other than those contained in the agreement and the offering circular. This may open the door to greater risk of ambiguity in understanding the exact scope and content of a franchise agreement if a dispute later arises because of some inconsistency between the offering circular and the agreement, but will at least be limited to those two documents, both of which are in control of the franchisor.

11. Material Information/Updating Requirements

Implication: neutral to slightly negative. The Staff Report retains the obligation to update a UFOC quarterly to reflect material changes within the quarter. This is a bright-line test much appreciated by franchisors.45 Franchisors have a duty under state franchise laws to update their offering circulars "upon the occurrence" of a material change (or in some states "within 30 days thereof"), and therefore, it is common practice for most franchisors to amend their offering circulars when such events occur and to re-disclose pending franchisees before closing (and even postponing closing transactions pending the expiration of the mandatory waiting periods), if such change would be material to the prospective franchisee’s investment decision.

Confusion is created, however, by the new duty that franchisors update their financial performance claims on an ongoing basis. Franchisors typically only update that information on an annual basis when they receive it from their franchisees and only disclose in their offering circular the historical financial performance information as of their preceding fiscal year end. The new requirement arguably could be read to require a franchisor to review its Item 19 disclosure throughout the year to determine whether a "material change" has occurred which would require on-going reporting of its franchisees to accomplish. It also may conflict with a

44 See Note 23, supra.

45 Staff Report at 219 to 224.
publicly-traded franchisor’s SEC reporting requirements that prohibit the franchisor from making
disclosures concerning its financial performance outside of its 10k and 10Qs.

12. Preemption

Implication: neutral. The standard for preemption articulated in the Staff Report is consistent with the current status of the law. The revised Rule provides that it does not preempt state law, except to the extent of inconsistency with the Rule. A state law is not deemed to be inconsistent if it provides equal or greater protection to franchisees. While it is clear that registration and review of the offering circular and impound provisions provide greater protection to franchisees, a number of the additional disclosures required by states are simply different and perhaps arguably inconsistent. NASAA and the states have been working to mitigate the impact of those inconsistencies over the past several years. On balance, subject to the considerations described in Part C.1, below, this aspect of the revised Rule should not have any appreciable impact on franchisors.

C. Implications for Franchisor Lawyers

1. The Franchisor Lawyer’s Initial Role

By overhauling the presale disclosure document, the Staff Report guarantees one thing: every franchisor selling franchises today will have to rewrite its disclosure document to some extent. The first job for franchisor lawyers, therefore, will be to guide their clients through the rewrite process.

The lawyers’ job would be easy if the Staff Report had adopted the 1993 UFOC Guidelines in toto as the new federal disclosure standard. As noted in Section II.M, however, the Staff Report diverges from the UFOC Guidelines in two key respects. In some places, the Staff Report eliminates or streamlines a UFOC disclosure that the FTC views as unnecessary or overly burdensome thereby easing the franchisor’s disclosure burden. In other places, the Staff Report modifies a UFOC disclosure that the FTC considers “broken” and in need of being fixed. At the same time, the Staff Report declines to preempt state franchise laws that afford prospective franchisees equal(333,755),(481,771) or greater protection than the federal standard. Consequently, in helping franchisors through the rewrite process, lawyers face the immediate challenge of having to evaluate an entirely new set of inconsistencies between the Staff Report and state franchise sales laws.

How franchisors and their legal counsel actually go about the rewrite process will depend primarily on three things: (1) whether the franchisor offers franchises in any registration states; (2) what, if anything, registration states do with their franchise sales laws once the revised Rule becomes final; and (3) how quickly the registration states respond, if at all.

46 Staff Report at 268 to 271.

47 The FTC has said there will be a phase-in period before the revised Rule becomes effective to give franchisors time to prepare their new disclosure documents, but hasn’t indicated how long it will be. Presumably it will be at least a year, which was the phase-in period allowed when the UFOC Guidelines were overhauled in 1993 and all franchisors had to rewrite their disclosure documents.

48 Staff Report at 16.
NASAA has said that once the revised Rule becomes final, NASAA will move swiftly in recommending changes to the UFOC Guidelines for its member states to adopt. At the May, 2005 IFA Legal Symposium, however, Dale Cantone, Chair of NASAA’s Franchise Project Group, said he doubts if NASAA members are prepared to accept those changes where the revised Rule falls short of mandating what the UFOC Guidelines now require by way of presale disclosure. Federal and state disclosure inconsistencies will remain part of the regulatory landscape. Franchisor attorneys will need to understand the interrelationship between the revised Rule and UFOC Guidelines in order to help their clients identify when the latter (as representing registration state maximum disclosure standards) provides "greater protection" to prospective franchisees.

Franchisor attorneys will have the opportunity to explain to their clients that unless states adopt parallel exemptions to those in the revised Rule, the franchisors will not be spared from franchise sales compliance burdens in registration states or see their legal budget appreciably reduced on account of the federal reforms. A franchisor exempt from the revised Rule, but not from a state’s franchise sales law, will still need to prepare a UFOC, register the offering where required, assign staff to keep the UFOC current, maintain franchise sales records detailing contacts with prospects, and monitor the activities of franchise brokers.

Similarly, unless and until the registration states adopt parallel delivery rules, the ability of franchisors to utilize the more visionary aspects of the revised Rule throughout the United States, like the proposed “pure” electronic disclosure, will remain in limbo. Franchisors may still have to count in business days in dealing with prospective franchisees in registration states since a 10 business day period may, in some instances, be longer than 14 days, resulting in the old delivery rules affording greater protection to a prospective franchisee.

How quickly, if at all, the franchise registration states can adopt the federal reforms is complicated by the fact that in some states the changes will require formal legislation instead of regulatory amendments. Regulatory changes are comparatively easier to accomplish than legislative changes and not as vulnerable to political wrangling.

As noted, the FTC as in 1979 declined the opportunity to preempt the field of presale disclosure and create one national disclosure standard. Consequently, the franchisor’s lawyer’s initial role, once the revised Rule becomes law, and unless and until the registration states react to the revised Rule, will be to manage their clients’ confusion over how to rewrite a disclosure document that satisfies both the federal disclosure baseline and each applicable registration state’s disparate requirements.

2. Long-Term Implications of the Revised Rule on Franchisor Lawyers

The final revised Rule will affect the advice and disclosure strategy that franchisor lawyers give their clients in a number of different substantive areas.

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49 Comments to the Staff Report filed by NASAA, the Washington Department of Financial Institutions and the Illinois Attorney General reveal that state regulators are not prepared to give up familiar UFOC disclosures that the FTC plans to eliminate, like cover page risk factors and Item 2 broker disclosures. See Part IV.D, infra.

50 The new compliance guidelines expected to be released by FTC staff will offer some assistance in this regard.

51 Staff Report at 269.
a. **Sophisticated Investor Exemptions**

The revised Rule would add exemptions for three categories of “sophisticated investor” transactions, *i.e.*, “large investments,” “large franchisees” and “insider transactions.”

For franchisors, the real benefit of these broad new exemptions is the possibility of being able to structure their franchise program, or set criteria for new franchisees, to take advantage of one of these exemptions and thereby avoid franchise sales regulation entirely, at least in non-registration states. Franchisor attorneys, accordingly, will be challenged to think outside the box in proposing creative structuring alternatives that enable their clients to sell franchises within the scope of one of the “sophisticated investor” exemptions without sacrificing core business objectives.

For example, a franchisor with a new franchise concept might consider testing the concept by confining initial franchise sales to insiders that qualify under the new federal “insider transaction” exemption. By running a pilot program in select markets in non-registration states and the handful of registration states that already have an equivalent exemption, a franchisor could largely avoid the delays, costs and legal exposure associated with franchise sales compliance.

Similarly, the “insider transaction” exemption makes it possible for a new franchisor to launch a franchise system in strategic markets free of franchise sales compliance costs. This could save a young franchise system significant legal dollars in the early years when finances are typically tight.

As noted in Section IV.B., the “large investment” exemption should benefit franchisors in certain industry sectors, like lodging, that require a significant capital investment, at least with respect to franchise sales in non-registration states.

Franchisor lawyers will have to counsel their clients in deciding whether an exemption from the federal disclosure obligation effects a sufficient cost saving, in light of the likely ad hoc

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52 These exemptions codify an FTC policy articulated in advisory opinions citing the FTC Interpretative Guides that a franchisee’s sophistication is relevant in evaluating whether the Rule should apply to a particular transaction. See e.g., Informal Staff Advisory Opinion 05-2, March 2, 2005. Public comments to the Staff Report’s proposed sophisticated investor exemptions range broadly from those questioning the wisdom of eliminating presale disclosure based on investment size or investor net worth to those urging various clarifications. At a minimum, the proposed sophisticated investor exemptions will likely be fine-tuned in the Compliance Guides.

53 Even thinking outside the box, franchisor counsel may find that the three “sophisticated investor” exemptions do not offer equal creative structuring opportunities. Of the three new exemptions, the “large franchisee” exemption seems to have more limited potential. While a franchisor conceivably could decide to rely on the “large franchisee” exemption in the initial years to launch a franchise system in non-registration states without worrying about Rule compliance, as a long-term strategy, a franchisor relying on the “large franchisee” exemption might end up sacrificing too many otherwise qualified candidates. This is particularly true if the initial investment to establish the franchise is relatively low and does not require a high net worth candidate to succeed.

54 California, Rhode Island, Washington and Wisconsin have statutory exemptions (subject to different conditions) for sales to sophisticated or experienced franchisees which may also work for purposes of a pilot program. Illinois and Maryland have regulatory exemptions that may also fit this situation.

55 At this time, only a handful of states currently have parallel exemptions for large investments or large franchisees. Unless registration states conform their laws by enacting parallel exemptions, creative structuring opportunities will continue to have to be market-specific.
requests for comparable investment information from prospective franchisees. Franchisor lawyers will be called upon to evaluate if the cost savings of an exemption will exceed the cost of satisfying investment information requests on an ad hoc basis, the potential liability risk of omitting material information about the franchise investment which would be disclosed in a complete UFOC meeting the revised Rule’s requirements, and the administrative cost of verifying that each transaction meets an exemption’s conditions.

Unless registration states already have, or adopt, parallel exemptions, the new “sophisticated investor” exemptions will only benefit franchisors in non-registration states. A franchisor selling in even one registration state would still need to prepare and maintain a UFOC. For this reason, franchisor attorneys may be quick to dismiss the utility of the new “sophisticated investor” exemptions. For a franchisor that can take advantage of one of these new exemptions, the benefit of no longer having to worry about FTC Rule compliance even in some 35 states is no small gain. Nevertheless, it will be franchisor’s counsel’s job to remind his or her client of the Rule’s geographic boundaries and to become familiar with the nuances of state franchise sales laws so that counsel may identify the registration states with an equivalent exemption and expand the utility of creative structuring solutions for their clients.

b. Formal Actions Against Franchisees (Item 3)

The revised Rule requires franchisors to disclose material civil actions that they bring against franchisees involving the franchise relationship during the last fiscal year. Attorneys representing franchisors will want to remind their clients that there is now a disclosure consequence in deciding to bring a formal action against a franchisee arising out of the contractual relationship.

Franchisor counsel may be required to evaluate when an action against the franchisee is one involving the “franchise relationship” and how like actions may be grouped together under a common heading, such as “royalty collection suits.”

Even before the revised Rule becomes final, franchisors may feel the impact of this disclosure change as decisions to file formal actions against a franchisee today could become a disclosure item if the matter remains pending when the revised Rule takes effect, or was initiated during the last preceding fiscal year of the franchisor. The potential disclosure may prompt lawyers to recommend informal dispute resolution alternatives to their clients, such as mediation or ombudsman programs, as a way to resolve disputes without having to disclose them to prospective franchisees.

c. Parent Guarantees and Corporate Structures (Items 1 – 4)

The revised Rule would add significant new disclosures about the franchisor’s parent companies not currently required by the UFOC Guidelines. The expanded disclosures about parents may prompt legal counsel to recommend that a franchise company reevaluate its corporate structure.

In Item 1, franchisors will have to identify all intermediate parent companies, not just the ultimate parent. For some public and private companies with elaborate corporate structures, this could bulk up the UFOC with information about intermediary entities not ultimately financially responsible for the franchise and not necessarily relevant to the franchisee. Changing from a parent-subsidiary corporate structure to one where the franchisor is a non-parent affiliate of an operating company and controlled by the same individuals could reduce the
need for extra Item 1 disclosures about other companies in the franchisor’s corporate tree that have no significance to the franchisee.

Revised Item 3 would extend litigation disclosures to a parent that guarantees the franchisor’s performance. Revised Item 4 would extend bankruptcy disclosures to any parent, not just a parent that guarantees the franchisor’s performance. Both represent material expansions of the current UFOC Guidelines, which now require Item 3 and 4 disclosures only for a franchisor’s affiliate that sells franchises under the same trademark as the franchisor or has done so in the past.

Depending on the parent company’s litigation and bankruptcy history, not only might franchisor counsel want to consider changing from a parent-sub to a non-parent affiliate corporate structure in order to avoid having to make extra disclosures in Items 3 and 4 about the parent’s past, but also may want to rethink the value of relying on a parent’s guaranty in lieu of providing the financial statements of the franchisor entity. This is particularly so when the parent’s net worth does not qualify the franchisor for an exemption from registration under the “large franchisor” exemption available under some state franchise laws. When a franchisor can escape registration by relying on a high net worth parent’s guaranty, the benefit of the parent’s guaranty may outweigh any marketing disadvantage caused by having to disclose negative information in Items 3 and 4 about the parent’s litigation and bankruptcy past. But when the parent lacks the net worth to qualify the franchisor for the “large franchisor” exemption from registration, the parent’s guaranty may be nothing more than a disclosure liability. The franchisor might instead opt to rely on a guaranty from an affiliate company that has no negative litigation or bankruptcy history. Alternatively, the parent or ultimate controlling entity might be better off forming a brand new non-parent affiliate company to serve as the franchisor.

d. Item 19 Information

The revised Rule would allow franchisors to give prospects detailed information about the cost to open and operate a franchise unit without requiring a formal Item 19 disclosure. Lawyers will want to get involved in reviewing cost data before their franchisor clients disseminate the information to prospective franchisees to verify that the data is not being disclosed in the context of other information which remains subject to regulation as a financial performance representation, like actual or hypothetical break-even points. Lawyers can also be helpful in discussing with their clients whether the expense data they disclose to prospects is consistent with their own actual experience or that of existing franchisees or requires any footnoting to explain material underlying assumptions that would be helpful to minimize the risk of misunderstandings.

The revised Rule in Item 19 would carve a narrow exclusion from general media claims for financial data that a franchisor posts on its website regardless of whether the data is incorporated in the franchisor’s SEC filings, press releases or news stories. Because of the ease with which a franchisor could make unintentional but inappropriate financial performance

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56 In its public comment to the Staff Report, NASAA urged the FTC also to require Item 3 and Item 4 disclosures for a non-parent affiliate guarantor. See, e.g., NASAA, Comment 34, at 4-5.

57 This particular Rule revision would finally put to rest years of confusion and debate over the current system, which treats unit cost and expense information as an "earnings claim" notwithstanding that UFOC Items 5-7 mandate that franchisors make disclosures about the cost to open and operate a franchise unit through the initial phase of the franchise business.
disclosures to prospective franchisees, franchisor lawyers will want to counsel their clients on how to stay within the narrow boundaries of this limited exclusion. A simple link from the franchisor’s franchise webpage to its SEC filings, for example, will nullify the exclusion. The Staff Report acknowledges the need for guidance on the relationship between general media claims and Item 19 disclosure obligations and promises to supply clarification in the Compliance Guides.58

e. **Franchisee Association Information (Item 20)**

The revised Rule would require franchisors to provide contact information in Item 20 for each franchisor-created franchisee organization and any incorporated independent franchisee organizations that request inclusion. In a franchise system where the only franchisee group is an independent collection of dissidents (albeit an incorporated collection), franchisor counsel may want to encourage their clients to establish a franchisor-sponsored franchise advisory council not only for the benefits that typically come from such a group (such as enhanced communication and creative input), but also to serve, more or less, as an antidote to the dissidents’ views, as an alternative resource for prospects to speak with about the franchise.

If franchisor-sponsored entities are considered, franchisor counsel will want to advise their clients about possible structuring approaches, e.g., should representatives be elected by franchisees, appointed by the franchisor, or both; should the entity be advisory or have decision-making authority; should the scope of the franchisee input be limited to marketing or extend to broader topics with strategic implications for the franchise system? Since the identity of independent franchisee associations will now be given to prospects, franchisor counsel may encourage their clients to explore ways to improve relations with these groups to increase the likelihood of receiving positive endorsements for the franchise program and establish areas of mutual benefit such as group buying programs.

f. **Specific Outlet Turnover Disclosures (Item 20)**

In addition to overhauling the charts in Item 20 and replacing them with five new tables designed to eliminate the double counting problem, the revised Rule would add a new provision to Item 20 requiring franchisors selling a specific existing unit to provide the prospective franchisee with a history of that unit’s owners for the last five fiscal years as a way of addressing the problem of “churning” and excessive turnovers. Franchisor counsel may want to help their clients evaluate if new disclosures that reveal churning will dampen future sales of that unit or others, and explore alternative solutions with their clients that regularly buy back units from terminated or poorly performing franchisees, such as ways to facilitate franchisee-to-franchisee sales.

g. **Conflict of Interest Disclosures (Item 2)**

The revised Rule would require franchisors to expose two areas of potential conflicts of interest not currently required by either the Rule or the UFOC Guidelines: if any company officer owns an interest in a competitor or supplier from whom the franchisor recommends or requires

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58 The Staff Report ratifies the current FTC position that general media claims do not include communications to financial journals or the trade press made in connection with bona-fide news stories or directly to lenders in connection with arranging financing for franchisees. Once the franchisor uses electronic or printed articles to market their franchises, they would be deemed to make a general media claim and, as a result, their UFOC would need to include a full Item 19 disclosure.
franchisees to buy equipment or supplies. The need to add these disclosures may prompt some franchisors to rethink their corporate policies allowing corporate officers to own interests in outside entities. Besides counseling their clients about the new conflict of interest disclosures, which may expose factors influencing system decisions possibly adverse to the financial interests of existing and prospective franchisees, franchisor counsel may be called upon to draft formal conflict of interest policies.

h. **Disclaimers and Contract Integration Clauses**

Lawyers for franchise companies will need to counsel their clients on the subtle difference between contract integration clauses and no-reliance clauses and how any contract provisions of this nature can be reconciled with the revised Rule. The revised Rule would forbid franchisors from requiring a prospect to disclaim or waive reliance on any representation made in the UFOC. It therefore will invalidate the kinds of no-reliance provisions often found in franchise contracts and closing statements. While franchisors presumably could still rely on contract integration clauses for specific purposes, among them to disclaim responsibility for unauthorized claims made by salespersons, 59 franchisors could not condition a franchise sale on the prospect signing a no-reliance statement that did not carve out and preserve the UFOC. Franchisor counsel will need to review their clients’ contracts, marketing materials and sales practices to determine if changes must be made on account of the new ban on no-reliance provisions.

i. **Confidentiality Clauses**

As the revised Rule will require franchisors to disclose if any current or former franchisees have signed a “confidentiality clause” during the last three fiscal years, restricting their ability to discuss with others their personal experience in the franchise system, 60 franchisor counsel will need to help their clients sift through the various countervailing considerations in deciding whether or not to include, and how exactly to phrase, confidentiality clauses in settlement agreements and other franchisee contracts.

Among other things, franchisors must weigh the potential damage from not using confidentiality clauses and having disgruntled existing or former franchisees be free to talk with prospects about their experiences in the system, against the harm to potential sales by using confidentiality clauses if they make it difficult for prospects to get meaningful information about the system from former or current members, or by creating an impression in the eye of prospective investors that something is being suppressed or that the atmosphere in the system is repressive.

59 Franchisors could still rely on a contract integration clause to block testimony regarding contrary statements by former or existing franchisees and statements made outside of the UFOC. The revised Rule would permit contract integration clauses to block claims that the franchisor might make in marketing materials or press releases, or even in the UFOC, if the claim, on its face, is not applicable to the prospect (e.g., financial performance representations regarding a particular geographic area where the prospect has no intention of locating its franchise). A number of public comments urged the FTC to narrow the exceptions to the prohibition against disclaimers. See, e.g., Bundy & Morrill, Comment 7, at 11-12; Haff, Comment 17, at 3; Legal Solutions Group, Comment 48.

60 No additional disclosure would be required when a confidential requirement restricts discussion about the franchisor’s proprietary information or trade secrets or things outside of the franchisee’s personal experience as a franchisee.
Franchisor counsel will want to help their clients assess if they care at all about revealing the existence of confidentiality clauses used in the past. Disclosures revealing the existence of confidentiality clauses might cast the impression of a troubled franchise system or heavy-handed, top-down franchisor management style that may turn away prospects. On the other hand, a franchisor that scrupulously includes a confidentiality clause in every franchisee contract may view the new disclosure as an opportunity to express and justify its corporate policy quietly.

The revised Rule would give franchisors discretion to disclose the number and percentage of current and former franchisees signing contracts during that time period with a confidentiality clause. Franchisors would not have to reveal the identity of former or current franchisees subject to a confidentiality clause by name. If confidentiality clauses have been used sparingly, franchisor counsel may want to recommend disclosing the small percentage of franchisees affected.

Because the disclosure under the revised Rule will reach back three years, franchisor counsel should begin discussing with their clients now the potential future consequence of having to disclose any confidentiality clauses that they write into franchise contracts today. Franchisor counsel may wish to explore how settlement, confidentiality and other franchisee contracts can be structured without preventing franchisees from discussing the franchise with prospective investors. Alternatives may range from adding language to a franchise contract that affirmatively grants permission to the franchisee to discuss personal experiences as a franchisee in the franchise system, to limiting the scope of a confidentiality provision to specific terms that do not relate to the franchisee’s personal experiences, or eliminating confidentiality clauses altogether.

D. Implications for NASAA

1. Preemption

Section 436.10 of the revised Rule would preempt state franchise law only to the extent of "inconsistent" state law. A state law will not be deemed inconsistent if it affords equal or greater protection to prospective franchisees. Examples of state law requirements that afford greater protection to prospective franchisees than the Rule include registration of disclosure documents or more extensive disclosures. This is substantially the same regulatory policy as has been in effect since the Rule was first promulgated in 1979.

This aspect of the proposed Rule thus suggests three things. First, the role of the registration states will not be ended, on the assumption that the oversight that accompanies registration provides a level of protection not present in and superior to non-registration states. Second, there may be state disclosure or registration laws or regulations, other than those which require more extensive disclosures, which would not be preempted by the Rule. Third, the preemption will not reach state franchise relationship laws. Accordingly, state-specific addenda to disclosure documents will continue to be used in many UFOCs.

While NASAA itself has made no public statement of intent regarding its response should the proposed Rule be adopted, the NASAA Franchise Project Group is well aware of the forthcoming opportunity to modify the UFOC Guidelines to reduce, if not eliminate, inconsistencies in disclosure document content and format as between the FTC’s "floor" and the more demanding requirements of some state laws. It is, therefore, not unreasonable to assume that NASAA will recommend that their constituent disclosure and registration states adopt a
UFOC template that matches, or is much closer to, the requirements of the FTC Rule as the standard of disclosure in their states. The more difficult question is the extent to which those states will insist that franchisors continue to comply with certain of their existing disclosure requirements that are perceived to afford greater protection for investors in their states.

2. **How Will the Registration States Adjust to the New FTC Rule?**

The process by which the new FTC Rule would affirmatively become the disclosure standard varies from state to state.

In the 38 states that do not have a separate state registration or prescribed presale disclosure requirement, the revised Rule will prevail as the only applicable disclosure standard.

Of the remaining dozen states with their own prescribed presale disclosure requirement, some states already sanction the use of disclosure documents that comply with federal law. For example, the Maryland statute allows the use of a prospectus that complies with the requirements of “… a unit of the federal government.” Minnesota, North Dakota and South Dakota allow their state administrators by rule or order to accept for filing a document that “…complies with the requirements of any federal law or administrative rule.” Hawaii allows the use of “…an offering circular or disclosure statement required by a federal … agency…”

California allows only the use of the UFOC format issued by NASAA in 1993. By contrast, the statutes of Illinois, Rhode Island, Virginia and Washington appear to be elastic enough to allow (subject to the discretionary approval of the state’s franchise law administrator) the use of the UFOC format as adopted by NASAA from time to time.

The New York statute provides that, “Any uniform disclosure document approved for use by any agency of the federal government or sister state may be utilized and sought to be registered, provided that said uniform disclosure documents comply with the provisions of this article.” Exactly what that requires isn’t entirely clear, but it seems unlikely that New York’s administrator, the Attorney General, would accept a revised Rule-compliant UFOC without some further adaptation to additional disclosure requirements found in the body of the New York statute.

Thus, some coordinating and planning will be required to clarify the readiness of the registration states for the eventual effective date of the new FTC Rule. We expect NASAA to issue a statement of policy providing guidance and recommendation to those states.

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61 MD Bus. Reg. Code Ann. § 14-215(b), 216 (a); Code of MD Reg. § 5200.04 A-B.


63 HI Rev. Stat. §§ 482E-3(e); HI Regs. § 16.37.-4(a)(c).

64 CA Corp. Code 31111(a); CA Admin. Code § 310.111.


3. **Areas Where Preemption May, or May Not, be Avoided**

   a. **Risk Factors**

   The proposed Rule eliminates the required use of risk factors on the Cover Page. The stated rationale is that the information is contained elsewhere in the body of the disclosure documents. For example, venue clauses, one of the risk factors used in the sample answer for the UFOC format, is required to be disclosed in Item 17(v). Some are of the view that risk factors tend to bring to the attention of the prospective franchisee that the investment does involve risk and may create a greater tendency to seek out legal advice before entering into the franchise agreement.

   b. **Brokers**

   There appears to be little enthusiasm for continuing application of the UFOC Item 2 disclosures requiring the listing of every franchise broker employed by or affiliated with the brokerage networks that have proliferated in recent years. This requirement was included in the NPR but the Staff Report recommends its deletion. On the other hand, some observers believe that NASAA may weigh in on the need for disclosure that makes clear to the prospective franchisee that the broker is paid by and owes his or her duty of loyalty to the franchisor. Litigation involving brokers used by the franchisor may also be the subject of state disclosure requirements.

   c. **First Personal Meeting Trigger**

   Only three states, Maryland, New York and Rhode Island mimic the 1979 Rule to require by statute that the disclosure document be delivered at the "first personal meeting." These states could well take the view that if a prospective franchisee is provided with the disclosure document at this earlier stage, there is a greater opportunity to begin the due diligence process before the sale is made. For this reason, the statutes in question are not likely to be found to have been pre-empted and thus could only be repealed by legislative action.

   d. **Expenses Only Financial Performance Information**

   The Staff Report states that information about prospective costs and expenses, standing alone, will not constitute the making of a financial performance representation under Item 19 and can be provided even if no Item 19 disclosure is made. While any such information provided would be subject to the general anti-fraud provisions of the Rule, the requirement of Item 19 that there be a "reasonable basis and written substantiation for the representation" will not specifically apply. In this change, the revised Rule would revert to the definition of "earnings claims" that prevailed from the original, 1974 UFOC through the 1993 revision, and is likely therefore to be acceptable to the registration states.

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67 Staff Report at 102.
e. Financial Statements Prepared Under Non-US GAAP

The proposed Item 23 would allow the use by foreign franchisors making franchise offerings in the U.S. of foreign financial statements not prepared under U.S. GAAP if the financial statements satisfy the criteria of the U.S. Securities and Exchange Commission, or as revised by any future government mandated accounting principles. Some are concerned that given the extensive other disclosures required by the SEC that accompany the financial statements, the use of unfamiliar foreign financial statements alone may not provide adequate disclosure to the prospective franchisee even if assisted by a certified public accountant in the United States.
Mark B. Forseth

Mr. Forseth currently is Vice President and Assistant General Counsel, Brand and Franchise Transactions for Marriott International, Inc. Among other duties, Mr. Forseth is responsible for responding to legal issues involving the development and operation of franchised hotels, and supervises the company’s franchise regulatory compliance for the seven hotel brands in the United States and Canada and four hotel brands internationally. Before joining Marriott, Mr. Forseth was in private practice for 8 years, focusing on representation of franchise and other distribution companies in both domestic and international markets, and related regulatory and relationship issues. Prior to that, Mr. Forseth was the Senior Franchise Examiner for the Maryland Division of Securities, responsible for enforcement of the Maryland Franchise Registration and Disclosure Law. Mr. Forseth is an advisor to the North American Securities Administrators Association Franchise Project Group and a member of: the American Bar Association - Forum on Franchising; International Franchise Association - Legal/Legislative and Corporate Counsel Committees; and Maryland Bar Association - Franchise Law Committee (Past Chairman).
Eric H. Karp

Eric H. Karp serves as counsel to numerous franchisee associations in such chains as McDonald's, Pearle Vision, Domino's Pizza, Denny's, TCBY Yogurt, Portable On Demand Storage, and Colors on Parade. He has represented franchisees throughout the country in a myriad of franchise issues.

Mr. Karp has twice been selected for inclusion in The International Who's Who of Franchise Lawyers, most recently in the 2004-2005 edition.

He served on the Board of Directors of the American Franchisee Association (AFA) for ten years. Mr. Karp also served as Chair of the AFA Model Responsible Franchise Practices Act Committee, was the principal author of the Model Act and served as the Program Chair of the 1999 AFA Franchisee Legal Symposium.

In June, 1994 Mr. Karp testified before the U.S. House Small Business Committee on "Self Regulation of Franchising: The IFA Code of Ethics." An elected delegate to the 1995 White House Conference on Small Business, Mr. Karp has twice testified before the Joint Committee on Commerce and Labor of the Massachusetts Legislature on franchise issues.

Since 1996, Mr. Karp has served on the Franchise Project Group of the Franchise and Business Opportunities Committee of the North American Securities Administrators Association. He has been a presenter at the American Bar Association Forum on Franchising and the International Franchise Association Legal Symposium.

Mr. Karp is an Adjunct Professor at the F.W. Olin Graduate School of Business at Babson College and serves on the Editorial Advisory Board of Andrews Franchise & Distribution Litigation Reporter.

Mr. Karp is a graduate of Boston University (B.A. Political Science 1974) and Boston University School of Law (J.D. 1977).
Andrew C. Selden

Mr. Selden is a shareholder of Briggs and Morgan, P.A., Minneapolis, Minnesota. He was Chairman of the Forum on Franchising, from 1985 to 1989; Editor of the Franchise Law Journal 1983-84; and Program Chairman of the 1985 Annual Forum; a member of the Forum's Governing Committee from 1983 to 1989. Mr. Selden was the Reporter of the Uniform Franchise and Business Opportunities Act promulgated by the National Conference of Commissioners on Uniform State Laws, and is a member, and former Chairman (1983-87), of the Industry Advisory Committee to the Franchise Regulation Committee of the North American Securities Administrators Association. Mr. Selden was an accredited delegate of the International Bar Association to the UNIDROIT conference on a model international franchise law. He has published articles on franchising and other topics in the FRANCHISE LAW JOURNAL, THE WALL STREET JOURNAL, THE BUSINESS LAWYER, the IFA FRANCHISE LEGAL DIGEST, and other publications, and has spoken at numerous programs on franchising and antitrust issues sponsored by the Forum on Franchising, International Franchise Association, Practicing Law Institute, Minnesota (and other states') continuing legal education, and the ABA Sections on Antitrust Law, and Patent, Trademark and Copyright Law. Mr. Selden was Chairman (1994-96) and is a member of the Board of Directors of the Better Business Bureau of Minnesota, Inc. He is listed in The Best Lawyers in America, and has been selected as a "Leading Minnesota Attorney." Mr. Selden's law practice involves representation of regional, national and international franchisors, national and global franchisee associations, and franchise system purchasing cooperatives.
Rochelle B. Spandorf

Rochelle Spandorf is a partner with Sonnenschein Nath & Rosenthal in its Los Angeles office and a member of the firm’s Antitrust, Marketing Practices, Franchising and Distribution practice group. She has over 25 years’ experience representing franchisors, manufacturers, licensors and suppliers in their domestic and international expansion and strategic development, concentrating on a broad spectrum of transactional and regulatory issues. Ms. Spandorf is the first woman to chair the American Bar Association’s Forum of Franchising (1995-97) and served on the Forum’s Governing Committee from 1992-99 and as program chair of its 1994 Annual Forum. She is a past Associate Editor of the Forum’s Franchise Law Journal, co-editor of the Forum’s publication, Building Franchise Relationships, a frequent speaker at Forum programs and author of numerous articles for the Forum’s Franchise Law Journal and The Franchise Lawyer. Ms. Spandorf has twice served as Chair of the California State Bar Franchise Law Committee and as a member of the State Bar Business Law Section Executive Committee. She is a member of the Editorial Board of LJN’s Franchising Business & Law Alert and has spoken extensively on franchising subjects on behalf of the International Franchise Association, American Bar Association, State Bar of California, California Continuing Education of the Bar and numerous professional organizations. She has taught franchise courses for the University of California at Santa Barbara and California State University, Dominguez Hills and Northridge campuses. She also serves as co-chair of the Southern California chapter of the Women’s Franchise Network for the International Franchise Association. Ms. Spandorf is listed in the International Who’s Who of Franchise Lawyers and was named a Super Lawyer by Los Angeles Magazine as one of Southern California’s best franchise and distribution attorneys in a survey of peers.