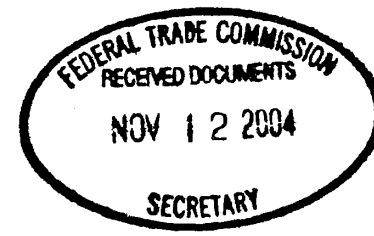
KAUFMANN, FEINER, YAMIN, GILDIN & ROBBINS LLP

ATTORNEYS AT LAW
777 THIRD AVENUE
NEW YORK, NEW YORK 10017

TELEPHONE (212) 755-3100
FACSIMILE (212) 755-3174
www.kaufmannfeiner.com

E-mail:dkaufmann@kaufmannfeiner.com



November 11, 2004

Secretary
Federal Trade Commission
Room H-159 (Annex W)
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580

Re: Franchise Rule Staff Report, R511003

Dear Sir/Madam:

This letter sets forth comments on the Federal Trade Commission ("FTC") Bureau of Consumer Protection's August 25, 2004 *Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436)* (the "Staff Report"), as invited both by the Staff Report itself and the Federal Register notice announcing same, and is submitted on behalf of:

(i) YUM! Brands, Inc. (owner of the Pizza Hut, KFC, Taco Bell, Long John Silvers and A&W All-American Food franchise networks, the world's largest quick-serve restaurant company in terms of system units with nearly 33,000 restaurants around the world in more than 100 countries and territories;

(ii) 7-Eleven, Inc., owner of the world's largest convenience store franchise network with over 24,000 stores worldwide;

(iii) Arby's, LLC, franchisor of the world famous Arby's franchise network, featuring over 3,400 Arby's restaurants worldwide, and owner as well of the T.J. Cinnamons Classic Bakery breakfast, snack and dessert concept; and,

(iv) The law firm of Kaufmann, Feiner, Yamin, Gildin & Robbins LLP, which serves (and has served over the past two decades) as franchise counsel to some of our nation's largest and most reputable franchisors, as well as a plethora of start-up and maturing franchisors.

I. INTRODUCTION

Given our lengthy service to and experience in the franchise sector of our economy; our participation in and close observation of the nine year regulatory review and rulemaking proceedings which ultimately gave rise to the Staff Report; and, our own experience in drafting and securing the passage of franchise regulatory legislation (the New York Franchise Act), we view the Staff Report as a work of stunning achievement. The Staff Report reflects extraordinary depth of intellect; a thorough understanding of the centrality, impact and import of franchising to the United States economy; a global vision; and, a remarkable effort to ascertain and, as prudent, incorporate in the Staff Report the desires, needs and policy positions both of franchisors who will be regulated by the forthcoming revised FTC Franchise Rule and franchisees whose interests are sought to be protected and advanced thereunder.

We believe that the franchise community owes a great debt of gratitude to those responsible for commissioning, authoring and overseeing the Staff Report - - Steven Toporoff (FTC Franchise Program Coordinator); Eileen Harrington (FTC Associate Director, Division of Marketing Practices); and, J. Howard Beales III (Director, FTC Bureau of Consumer Protection).

While we believe that certain provisions (as identified below) of the Staff Report and proposed revised FTC Franchise Rule may yet require some "fine tuning" before final Rule adoption, we are most confident that - - given the Commission's demonstrated proclivity to capture and respond to a broad universe of input - - the final revised FTC Franchise Rule ultimately adopted should serve the franchise industry extraordinarily well over the coming decades.

We believe that the suggested changes to the proposed revised Franchise Rule identified in this letter will protect franchisors from unnecessary (and likely unintended) duties and liabilities without diminishing in any respect the ultimate goals of the Franchise Rule - - the elimination of fraud in the franchise sales marketplace and the ability of prospective franchisees to make informed investment decisions.

II. ELECTRONIC DISCLOSURE - - FORMAT NOTIFICATION

Section 436.6(f) of the proposed revised Franchise Rule establishes a condition precedent to a franchisor engaging in electronic disclosure by providing: "Before furnishing a disclosure document, the franchisor shall advise the prospective franchisee of the formats in which the disclosure document is made available, any prerequisites for obtaining the disclosure document in a particular format, and any conditions necessary for reviewing the disclosure document in a particular format".

This new precondition to electronic disclosure, not previously raised in the Commission's 1999 Notice of Proposed Rulemaking ("NPR"), appears designed to supplant the NPR's "prior consent" precondition to electronic disclosure (under which such disclosure could be effected only with the prior consent of the prospective franchisee) and, as the Staff Report elucidates, is meant to ensure that prospective franchisees know whether or not they will receive a disclosure document in a form they can easily use (*Staff Report* at 216).

The Staff Report elaborates on the proposed revised Rule's directive regarding format notification by stating:

> A franchisor would disclose if it furnishes disclosures, for example, via CD ROM only. In addition, the franchisor must disclose if there are any special conditions to reviewing a disclosure document. For example, the franchisor would disclose whether the prospective franchisee's computer must be capable of reading pdf files or whether any specific applications are necessary to view the disclosures (such as Windows 2000 or DOS, or a particular Internet browser) (*Id.*).

Neither the Staff Report nor the proposed revised Franchise Rule further addresses what type of "format notification" the above-quoted Rule provision would require, nor when such notification should be effected. Indeed, the above-quoted language could (mistakenly, we believe) be construed as negating the possibility of pure electronic disclosure by interposing a "paper notice" requirement.

We do not believe that this is what the Commission staff has in mind. Instead, we surmise that given the Staff Report's visionary and enlightened adoption of a pure electronic disclosure protocol, insisting on a paper "format disclosure" document is not what is intended.

Accordingly, we respectfully suggest that the Commission make clear in its forthcoming FTC Franchise Rule Compliance Guides (which, according to the Staff Report, will accompany the promulgation of the ultimate revised FTC Franchise Rule) that a franchisor will be able to communicate its disclosure format information in any fashion and at any time prior to furnishing the disclosure document that it chooses - - in person; telephonically; in writing; through e-mail; in its franchise marketing materials; in franchise application forms; or, otherwise.

III. DISCLOSURE TO PROSPECTIVE FRANCHISE TRANSFEREES

A provision of the proposed revised Franchise Rule would, for the first time in franchise regulation history, require franchisors to engage in disclosure during the franchise transfer process (that is, in connection with the sale, assignment or other disposition of an existing franchise by a current franchisee) circumstances where the franchisor was not entering into any new agreement with the transferee and otherwise had no involvement in the transaction other than to approve or disapprove the proposed transfer. This requirement is extant neither in the current FTC Franchise Rule nor in any state franchise registration/disclosure statute.

Specifically, proposed Section 436.9(f) of the revised Rule would make it an unfair or deceptive act or practice for a franchisor to "(f)ail to furnish existing disclosures to a prospective purchaser of an existing franchised outlet, upon reasonable request".

The Staff Report justifies the imposition of this new requirement by observing:

> ...(W)e recognize that an argument can be made that all prospective transferees should be entitled to the benefits of pre-sale disclosure in order to make an informed investment opportunity. However, we would not go that far. For example, a franchisor may have stopped selling franchises when an existing franchisee decides to sell his or her unit. If so, it would be unreasonable to compel a franchisor to incur the costs of creating a disclosure document solely to assist an existing franchisee in selling his or her unit. Rather, we believe that a better approach would to be to create a new prohibition barring franchisors from failing to furnish a prospective transferee with a copy of an existing disclosure document upon reasonable request (*Staff Report* at 66).

Under the current Rule and all state franchise laws, franchisors not directly involved in franchisee transfer transactions (other than to exercise their contractually reserved right, if any, to approve or disapprove the subject transaction) have no disclosure obligations whatsoever to the prospective transferee (*FTC Franchise Rule Final Interpretive Guides*, 44 Fed. Reg. at 49,969). Conceivably, this is because - - as the Staff Report itself observes - - "...the purchaser (in such circumstances) is not relying on any sales representations of the franchisor, but on the terms and conditions spelled out in the existing contract" (*Staff Report* at 65).

Yet by compelling franchisors to inject themselves and their disclosure documents into such transactions, the wisdom of current FTC policy on the issue will be eradicated and, instead, franchisors may find themselves "deep pocket" co-defendants in any subsequent action or proceeding claiming impropriety in the franchise transfer

transaction by the selling franchisee. Especially since the franchisor's disclosure document will almost always prove misleading to prospective transferees, since that disclosure document is geared not to them, their investments or the franchise agreements they will be assuming but, instead, to the interests of franchisees entering into the franchisor's current form of franchise agreement, almost always for a newly established unit. Accordingly, the franchisor's disclosure document will set forth initial investment, continuing royalty, advertising contribution and a host of other data which may be wholly inapposite to franchise transferees (particularly if the franchisor's current franchise agreement, as described in the disclosure document being furnished to the prospective transferee, contains payment and other obligations markedly different from the older form of agreement which is the subject of the transfer).

In addition, because the Staff Report (as quoted above) believes it would be unreasonable to compel a franchisor to create a disclosure document solely for the benefit of a franchise transferee, the revised Rule compelling transferee disclosure only states that a franchisor must furnish its "existing disclosures" to a prospective franchisee. The Staff Report elucidates that if a franchisor has ceased selling franchisees, then no transferee disclosure obligation would pertain.

However, what if the subject franchisor stops selling franchises everywhere except Hawaii (where it maintained its registration of a current franchise disclosure document) and the franchised unit to be transferred is located in Maine - - conceivably, the revised Rule would require the franchisor to furnish to the prospective Maine transferee a copy of its Hawaii disclosure document, yet further increasing the likelihood of a subsequent fraud claim against the franchisor by the transferee (since, in addition to all of the other possibly inapplicable data in the disclosure document referenced above, we add the twist that all such data is or may be geared to a very different state, a crucial distinction in any franchise sector where seasonality, climate and demographics account for widely varying unit economics). Further, posit the difficulty where a franchisor's only "existing disclosure" pertains to a different type of unit than that which is the subject of the transfer transaction - - an "express" restaurant versus the full "sit down" unit being transferred, or a 1,500 room resort hotel versus the 150 room suburban hotel being transferred. Again, the "existing disclosure" will prove not only inapplicable but misleading to the prospective transferee, engendering possible franchisor liability where none properly should exist.

Conceivably, neither the FTC Staff nor the revised Rule intends for such a result to pertain, since the franchisor in such transfer scenarios would not be deemed a "franchise seller" as that term is defined by the revised Rule (note, however, that neither is the selling franchisee deemed a "franchise seller" under the revised Rule). Presumably, the goal that the FTC Staff hopes to achieve is merely affording

transferees the opportunity to review at least some type of disclosure before consummating the transfer transaction.

However, given the presumably unintended dangers and liabilities which may be thrust upon franchisors as a result of the proposed revised Rule's new transferee disclosure requirements and the fact that such disclosure will often (perhaps almost always) prove misleading to prospective transferees of existing franchised outlets, we respectfully suggest that the Commission eliminate any such transferee disclosure requirement in the final revised FTC Franchise Rule.

IV. FINANCIAL PERFORMANCE REPRESENTATIONS - - "GENERAL MEDIA CLAIMS"

One possible difficulty with the revised Rule's treatment of financial performance representations concerns its retention of the notion that such representations made in the "general media" fall within the embrace of Item 19 requirements, restrictions and prohibitions (requiring identification of the universe of outlets under consideration, relevant dates of representation, number and percentage of outlets of the measured universe that actually attained or surpassed the stated results, characteristics of the included outlets, and so forth).

Clearly, it would be hard to argue that advertisements solely or predominantly geared to soliciting prospective franchisees should be so restricted.

However, both under the current and proposed revised FTC Franchise Rule, "general media" claims are deemed to include not only advertising but also statements made in speeches or press releases (see *Staff Report* at 30-31 and f.n.120 and *Final Interpretative Guides* at 49,984-85). As is the case under the current Rule, the revised Rule would except from this "general media" definition, "communications to financial journals or the trade press in connection with bona fide news stories..." (*Staff Report* at 31), as well as communications made directly to lenders in connection with arranging financing for a franchisee (*Id.*). The Staff Report states that these exceptions will be set forth in the forthcoming FTC Franchise Rule Compliance Guides (*Id.* at 31).

This broad definition of "general media" has caused, and if maintained in the final Franchise Rule will continue to cause, difficulty for franchisors. For it subjects them to liability for financial performance information disseminated by franchisor executives in speeches, press interviews or other forums not specifically geared to the franchise sales process unless such financial performance information appears in their company's disclosure document.

Consider whether the policy instead should be that such information should only be characterized as "financial performance representations" if it appears in oral or written statements given by franchisor executives that are specifically or primarily designed to influence a prospective franchisee's investment decision, lest an enormous chilling effect and vast liabilities attach to the ordinary business practice of addressing business audiences and granting interviews to the general press (as opposed to the "financial journals or trade press" which, as noted above, the Commission exempts).

Indeed, the Commission staff itself notes in its Staff Report:

> ...(T)he Staff has previously advised that the dissemination of financial data through bona fide news stories may generate benefits to the public that outweigh potential harm to prospective franchisees. For example, such information may be useful to potential suppliers seeking growing businesses as customers; shopping center or mall developers seeking promising franchise systems as tenants; and, financial analysts who follow market or industry trends. Accordingly, the exemption from the general media earnings claims disclosure requirements (for financial journals and, per the revised Rule, Internet content not specifically targeted to prospective franchisees) ensures that the Rule does not chill the free flow of newsworthy information about franchising or particular franchise systems (*Staff Report* at 31, f.n.119, citing FTC Advisory 97-5, Bus. Franchise Guide [CCH] ¶6485 at 9687 [July 31, 1997]).

It was on this basis that the FTC exempted the dissemination of financial performance representations to "financial journals or the trade press" from the Rule. But the question remains - - why should franchisor executives not be free to similarly aid those sectors of the public referenced above by giving interviews to *USA Today, CNN* or the *New York Times*?

We suggest that a more logical approach would be to permit franchisors and their executives to disseminate such information in the general media freely - - but subject such representations to the financial performance representation restrictions and requirements of the forthcoming revised FTC Franchise Rule only if memorializations of same are subsequently used to influence a prospective franchisee's investment decision (i.e., by means of the franchisor duplicating and utilizing the published or broadcast representations as part of its franchise marketing effort).

V. LIABILITY FOR CONTENTS OF DISCLOSURE DOCUMENTS

The current FTC Franchise Rule does not specifically address who is liable for the contents of a franchise disclosure document; it only provides that franchisors and

franchise brokers are jointly and severally liable for furnishing disclosures (16 CFR §436.1(a); *Final Interpretative Guides* at 49,969).

Section 436.2(d) of the revised Rule supplants this vacuum by expressly denominating those who bear liability for ensuring that the contents of a franchisor's disclosure document are full, complete, truthful and prepared in accordance with the revised Rule's requirements:

> In connection with the offer or sale of a franchise to be located in the United States of America... it is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act: (d) For any franchisor to fail to include the information and follow the instructions in (the revised FTC Franchise Rule) when preparing the disclosure document to be furnished to a prospective franchisee. Any other franchise seller will be liable for the violations of (the disclosure document preparation and contents requirements of the Rule) if they either directly participated in them or had the authority to control them.

That a franchisor (or, as applicable, a subfranchisor) would be liable under the revised Rule for failing to prepare a disclosure document in that fashion, and containing all of the disclosures, required by the Rule is, of course, hardly surprising.

However, caution must attend the last sentence of Section 436.2(d) of the revised Rule, as quoted above, which imposes liability on other "franchise sellers" if they either participated in or had the "authority to control" a violation of the revised Rule's disclosure document preparation and contents provisions.

Specifically, all senior officers of a corporate franchisor could technically be deemed to have the "authority to control" the contents of their company's franchise disclosure document and - - under the above-quoted revised Rule language - - could thus automatically assume liability for disclosure content failures that they were never aware of, did not know of, should not have known of and had utterly no responsibility for. Should the revised Rule maintain this provision, such liability could pertain not only in FTC enforcement actions but in private actions brought by franchisees under state "little FTC" statutes.

We submit that it is one thing for the revised Rule, as it does in the above-quoted language, to impose liability upon a corporate franchisor's officer for directly participating in a disclosure document content violation (i.e., omissions, misstatements or failures to follow Rule instructions), a liability co-extant with that found under many state franchise registration and disclosure statutes. For example, the New York Franchise Act imposes liability upon any officer, director or management employee

"...who materially aids in the act or transaction constituting the violation (of the Act)... It shall be a defense to any action based upon such liability that the defendant did not know or could not have known by the exercise of due diligence the facts upon which the action is predicated" (New York Franchise Act, General Business Law of New York, Article 33, §691[3]).

However, we submit that the revised Rule's "authority to control" language quoted above could (we believe wholly unintentionally) impose liability on the entire panoply of a franchisor's officers, directors and senior management team for disclosure document errors, omissions, misrepresentations or format failures which they did not participate in; knew nothing about; and, given their rank and duties, probably should not have known about. The larger the franchisor, the greater the possibility this result will pertain.

VI. PREEMPTION

Section 436.10(c) of the revised Rule provides that - - as is currently the case - - it does not intend to preempt the franchise laws of any state except to the extent of any inconsistency with the revised Rule.

Naturally, since the revised Rule would expand upon, and add to, the current UFOC Guidelines disclosure requirements mandated by the states, it would - - as observed by the Staff Report (at 269) "...create a new disclosure floor with which all franchisors must comply" and which, presumably, the states will require and accept.

However, many of the more striking features of the revised FTC Franchise Rule - - including, most notably, "pure" electronic disclosure and the exemptions from disclosure afforded by Section 436.8 of the proposed revised Rule - - have no analogs in most extant state franchise registration and disclosure statutes. While clearly such Rule provisions not governing disclosure document contents will have no preemptive effect upon the franchise regulating states, nevertheless, it would be disheartening if these more visionary aspects of the Franchise Rule were not adopted by them. For otherwise, these salutary new Rule features would be confined for use only in the 35 states which have no franchise registration and disclosure statutes and are thus governed exclusively by the FTC Franchise Rule. Such a dysfunctional result - - a "patchwork quilt" of electronic disclosure protocols and disclosure exemptions - - will prove quite detrimental to, and add to the administrative and financial burden of, our nation's large, national franchisors, putting them at a competitive disadvantage to non-franchised networks.

We know full well and truly admire the fact that the government officials responsible for federal and state franchise law administration have historically proven

remarkably cooperative and diligent in their efforts to harmonize federal and state franchise regulation in a collegial and effective manner. In this vein, we strongly urge the Commission to work with NASAA and the franchise regulating states in an effort to achieve nationwide implementation of some of the proposed revised Rule's more visionary provisions, most notably pure electronic disclosure and the disclosure exemptions denominated in Section 436.8 of the proposed revised Rule.

VII. PUBLISHED COMMENTARIES ON STAFF REPORT/PROPOSED REVISED RULE

Attached to this letter are three published commentaries regarding the Staff Report and the proposed revised FTC Franchise Rule addressed therein which were either authored or, in the case of the ABA *Franchise Law Journal* paper, co-authored by the undersigned.

These commentaries appeared in:

(i) The October 26, 2004 edition of the *New York Law Journal*;

(ii) The November/December, 2004 edition of *Franchise Times*; and,

(iii) A paper distributed and presented at the American Bar Association's 27th Annual Forum on Franchising, conducted October 6 – 8, 2004 in Vancouver, Canada.

* * * *

We strongly commend the efforts of the Commission and its staff which led to the promulgation of the Staff Report and the proposed revised FTC Franchise Rule. These efforts have been informed by remarkable intellect, imagination and responsiveness. Their objective - - the modernization of federal franchise regulation in response to the massive changes in the economy, society, demographics, technology and franchising which have transpired over the past quarter century - - has been equaled in ambition by the impressive effort undertaken by the Commission to ensure that it was taking the proper steps to achieve that goal.

We thank the Commission for the opportunity to submit the within comments and stand ready to answer any questions the Commission may have or otherwise assist it in such fashion as the Commission may desire.

Very truly yours,

KAUFMANN, FEINER, YAMIN,
GILDIN & ROBBINS LLP

By: DAVID J. KAUFMANN

DJK:tm
Enclosures

New York Law Journal

Tuesday, October 26, 2004

David J. Kaufmann, *Franchising, "FTC Set to Revamp Federal Franchise Rule"*

BY DAVID J. KAUFMANN

FTC Set to Revamp Federal Franchise Rule

That's not just the autumn breeze you are feeling. No, that's the wind ushering in a new era of franchise regulation, one highlighted by vision, dedication and a deep bow to technology.

On Aug. 25, 2004, the Federal Trade Commission's (FTC) Bureau of Consumer Protection issued its Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule — Disclosure Requirements and Prohibitions Concerning Franchising (the staff report) detailing the fashion in which the bureau proposes to revise the FTC Franchise Rule (16 CFR 436) in a "top-down" fashion for the first time since it took effect in 1979. Accompanying the staff report is the text of the proposed successor FTC Franchise Rule (the revised rule) which the staff recommends the commission adopt.

The staff report is a visionary and remarkable accomplishment, reflecting the commission's dedicated commitment to ascertain in detail: the current status of franchising; its role in the American economy; the needs and wants of franchising's "players" (franchisors, franchisees, those professionals who serve them and the public at large); and the vast demographic, economic, societal and technological changes that have transpired since the promulgation of the current FTC Franchise Rule in 1979. Franchising owes a sincere debt of gratitude to those responsible for aggregating the staff report — Steven Toporoff (FTC franchise program coordinator); Eileen Harrington (FTC associate director, Division of Marketing Practices); and J. Howard Beales III (director, FTC Bureau of Consumer Protection).

Dramatic Transformation

If the FTC Franchise Rule is ultimately revised in the fashion recommended by the staff report (and it almost certainly will be, perhaps with some very minor modifications following the brief comment period provided for in the staff report, which terminates on Nov. 12, 2004), the regulation of the offer and sales of franchises in the United States will undergo its most dramatic transformation since the enactment of federal and state disclosure laws and regulations in the 1970s and '80s.

While the staff report does not indicate when the commission will move to adopt the revised Franchise Rule appended thereto (as same may be further modified following the aforementioned comment period), public remarks lead this author to speculate that the revised rule will likely be adopted some time in mid-2005 with an effective date some time in 2006 (perhaps January 2006 with a "phase in" period of six months).

Gone under the proposed revised rule would be the existing Franchise Rule's coverage of business opportunities. Instead, the revised rule will exclusively focus on franchising (with the staff report suggesting that the FTC engage in a separate rulemaking for a new, revised business opportunity regulation).

Gone, too, will be the current rule's own format of disclosure. Instead, the revised rule will adopt the state ordained Uniform Franchise Offering Circular (UFOC) format, but with a twist: the revised rule would layer on additional disclosure requirements (and some modified disclosure requirements) from those currently required by the UFOC format, "UFOC plus" as it were. Mirroring state UFOC mandates, the revised FTC Franchise Rule would require disclosure documents to be prepared in "plain English."

Key Modifications

Among the most important new (or modified) disclosures and requirements under the proposed revised rule — not currently required under any federal or state franchise law or regulation — are the following:

- any competitor in which an officer of the franchisor holds an interest;
- any material litigation commenced by franchisors against their franchisees over the prior year (currently, only franchisee litigation against franchisors is required to be disclosed);
- an identification of any officers of a franchisor's corporate parent who will exercise management responsibility over the subsidiary franchisor's sales or franchise operations;
- all government litigation against any franchisor affiliate that offers franchises;
- all payments that a franchisee will be required to make to third parties in order to operate the subject franchise (even if the amount of those fees are unknown by the franchisor, in which case, that fact must be disclosed);
- whether any officer of the franchisor owns an interest in any required supplier;
- expanded disclosure regarding franchisor competition forthcoming from alternative channels of distribution (such as the Internet);
- required "Item 19" financial performance representation preambles (to the effect that the law permits franchisors to make financial performance representations in their disclosure documents and that, if none appear in those documents, any such representations otherwise forthcoming from franchisor personnel should be disregarded and instead reported to government agencies);
- all franchisee associations (not just "captive" associations), if they are incorporated and asked to be included in the disclosure document; and
- a new required statement if the franchisor utilizes confidentiality clauses precluding or limiting existing franchisee communications with prospective franchisees.

Gone as well under the proposed revised rule will be any question as to whether the FTC Franchise Rule governs franchise sales activity outside of the United States. The revised rule would make it explicitly clear that it applies only to the sale of franchises to be situated with-

David J. Kaufmann, *senior partner of Kaufmann, Feiner, Yamin, Gildin & Robbins, wrote the New York Franchise Act and represents franchisors nationwide.*

Continued on page 5

FTC Set to Revamp Federal Franchise Rule

Continued from page 3

in the United States, its territories and possessions.

Most critically, also gone under the proposed revised rule will be the days when disclosure documents had to be prepared and handed out in paper form. Instead, the revised rule would permit franchisors to engage in "pure" electronic disclosure by e-mailing disclosure documents; furnishing them to prospective franchisees on computer disks or CD-ROMs; or making them available for access over the Internet (with franchisee receipts, too, permitted to be obtained electronically).

Timing Requirements

Scheduled to vanish under the revised rule as well are the current FTC Franchise Rule's timing requirements, which require franchisors to furnish their disclosure documents to prospective franchisees at the earlier of the "first personal meeting" or 10 business days prior to the franchisee's execution of any contract or the payment of any money to the franchisor. Under the revised rule, the new disclosure "trigger" will be a simple 14 days prior to the franchisee's execution of any agreement or its payment of any money. The current requirement that "execution-ready" contracts be furnished to prospective franchisees in advance will also be scrapped (unless the franchisor has unilaterally and materially modified those agreements from the samples set forth in its disclosure document).

What the revised FTC Franchise Rule does not say is almost as important as what it does. It will not require franchisors to furnish financial performance representations (historically referred to as "earnings claims") in their disclosure documents if they elect not to do so. Indeed, the revised rule would permit franchisors to do something currently forbidden — furnish prospective franchisees with franchise cost or operating expense information standing alone even if no financial performance representations are set forth in the disclosure document.

The revised rule's silence disposes of another critical issue. The staff report makes clear that the forthcoming revised rule will in no fashion govern the post-sale relationship between a franchisor and its franchisees, despite strong calls by franchisee advocates that it does so.

The revised rule will not require franchisors to disclose financial performance ... [earnings claims].

In another striking change, the revised FTC Franchise Rule would permit franchisors to furnish their disclosure documents not just to prospective franchisees themselves, but to their "representatives" (attorneys, accountants or other agents).

While the revised rule would expand upon its current protection of prospective franchisees through the increased disclosure requirements detailed above, it also contains a salutary benefit to franchisors — a series of "sophisticated investor" exemptions from disclosure that do not currently exist under the FTC Franchise Rule (for prospective franchisees that meet certain net worth, investment and/or experiential parameters).

As is currently the case, the revised FTC Franchise Rule will not preempt the franchise laws of any state (unless they afford less disclosure than the rule requires). However, the "UFOC plus" elements of the revised rule would create a new disclosure floor that all franchisors must comply with and that the states will almost certainly require and accept. While many of the more striking features of the revised FTC Franchise Rule — first and foremost "pure" electronic disclosure — have no analogs in extant state franchise laws, it should be observed that the government officials responsible for federal and state franchise law administration have historically proved remarkably cooperative and diligent in their efforts to harmonize their respective interests in a collegial and effective manner.

Conclusion

The staff report and proposed revised FTC Franchise Rule are works of stunning achievement and are global in vision; they reflect extraordinary intellect and include a remarkable effort to ascertain and, as prudent, incorporate the normative desires and policy positions both of franchisors who will be regulated by the revised rule and franchisees whose interests are protected and advanced thereunder.

Naturally, this column will closely monitor developments regarding FTC adoption of the revised rule and report to you as they transpire.

THERE'S *BEAUTY* IN THIS ISSUE

Franchise Times

The News and Information Source for Franchising www.franchisetimes.com November/December 200

The Rule: A glimpse into the future

As the FTC Rule gets updated, the sale of franchises in the United States will undergo a dramatic transformation. Here's how the FTC's rule impacts franchising at home. For the International view, see page 67.

By David J. Kaufmann

The future of franchise regulation in the United States is coming into focus—and the view is crystal clear.

On August 25, 2004, the staff of the Federal Trade Commission issued a report detailing its recommendations as to how the FTC Franchise Rule—which requires franchisors to make full pre-sale disclosure prior to the offer or sale of any franchise—should be comprehensively revised for the first since it took effect in 1979.

If the FTC Franchise Rule is retooled as suggested by the FTC Staff Report (and it almost certainly will be, perhaps with some very minor modifications), the regulation of the offer and sale of franchises in the United States will undergo a dramatic transformation.

Gone will be the existing Franchise Rule's coverage of business opportunities. Instead, the revised Rule will exclusively focus on franchising.

Gone, too, will be the current Rule's own format of disclosure. Instead, the revised Rule will adopt the state ordained Uniform Franchise Offering Circular (UFOC) format, but with a twist: The revised Rule would layer on additional disclosure requirements (and some modified disclosure requirements) from those currently required by the UFOC format—"UFOC plus," if you will. Mirroring state UFOC mandates, the revised FTC Franchise Rule would require disclosure documents to be prepared in "plain English."

Also eliminated will be any question as to whether the FTC Franchise Rule governs franchise sales activity outside of the United States. The revised Rule would make it explicitly clear that it applies only to the sale of franchises to be situated within the United States, its territories and possessions.

Most critically, gone will be the days when disclosure documents had to be prepared and handed out in paper form. Instead, the revised Rule would permit franchisors to engage in "pure" electronic disclosure by e-mailing disclosure documents; furnishing them to prospective franchisees on computer disks or CD-ROM's; or, making them available for access over the Internet (with franchisee receipts permitted to be obtained electronically).

Scheduled to vanish under the revised Rule as well are the current FTC Franchise Rule's timing requirements, which require franchisors to furnish their disclosure documents to prospective franchisees at the earlier of the "first personal meeting" or 10 business days prior to the franchisee's execution of any contract or the payment of any money to the franchisor. Under the revised Rule, the new disclosure "trigger" will be a simple 14 days prior to the franchisee's execution of any agreement or its payment of any money. The current requirement that "execution ready" contracts be furnished to prospective franchisees in advance will also be scrapped (unless the franchisor has unilaterally and materially modified those agreements from the samples set forth in its disclosure document).

What's not said

What the revised FTC Franchise Rule does not say is almost as important as what it does. It will not require franchisors to furnish financial performance representations (historically referred to as "earnings claims") in their disclosure documents if they elect not to do so.

Indeed, the revised Rule would permit franchisors to do something currently forbidden—furnish prospective franchisees with franchise cost or operating expense information standing alone even if no financial performance representations are set forth in the disclosure document.

The revised Rule's silence disposes of another critical issue. The Staff Report makes clear that the forthcoming revised Rule will in no fashion govern the post-sale relationships between a franchisor and its franchisees, despite strong calls by franchisee advocates that it do so.

In another striking change, the revised FTC Franchise Rule would permit franchisors to furnish their disclosure documents not just to prospective franchisees themselves, but to their "representatives" (attorneys, accountants or other agents).

While the revised Rule would expand upon its current protection of prospective franchisees through increased disclosure (including, for the first time, disclosure regarding litigation commenced by franchisors against their franchisees; identification of both "captive" and independent franchisee associations; and, details regarding franchisee payments required to be made to third parties), it also contains a salutary benefit to franchisors—a series of "sophisticated investor" exemptions from disclosure that do not currently exist (for prospective franchisees which meet certain net worth, investment and/or experiential parameters).

As is currently the case, the revised FTC Franchise Rule will not preempt the franchise laws of any state (unless they afford less disclosure then the Rule requires). However, the "UFOC plus" elements of the revised Rule would create a new disclosure floor which all franchisors must comply with and which the states will almost certainly require and accept. While many of the more striking features of the revised FTC Franchise Rule—first and foremost "pure" electronic disclosure—have no analogs in extant state franchise laws, it should be observed that the government officials responsible for federal and state franchise law administration have historically proven remarkably cooperative and diligent in their efforts to harmonize their respective interests in a collegial and effective manner.

The Staff Report does not indicate when the Federal Trade Commission will adopt the revised Franchise Rule, as may be further modified following the comment period. FT

David Kaufmann is senior partner of New York City's Kaufmann, Feiner, Yamin, Gildin & Robbins LLP. He authored New York's franchise statute, the New York Franchise Act; and is an advisor to the organization of state and federal officials responsible for devising and coordinating franchise regulatory activity nationwide. He can be reached at dkaufmann@kaufmannfeiner.com.

How we got to where we're going

The FTC Franchise Rule took effect in 1979 after the franchise arena had become permeated by widespread fraud and criminality.

As modern franchising exploded in the 1950s and 60s, widespread press accounts about the wealth to be garnered in this burgeoning sector—by franchisors and franchisees alike—quickly captured the attention of the criminal community in general and, in some sections of the country, organized crime. Tens of thousands of people nationwide collectively lost hundreds of millions of dollars to criminal franchise enterprises which, utilizing slick brochures, sold phantom, non-existent franchises to hapless victims.

In response, California enacted the first franchise disclosure law in 1971, followed over the ensuing decade by 14 other states. The same year that California enacted its franchise statute, the Federal Trade Commission launched proceedings which led to the promulgation of the FTC Franchise Rule, which ultimately took effect in 1979.

The Rule remained unchanged since then, prompting the FTC in 1995 to conduct a regulatory review to find out if there was a need for it and, if so, how the Rule could be improved in light of the massive industry, societal, economic and technological changes which transpired since the Rule first went into effect. Over the past nine years the Commission published several rulemaking notices seeking comment on how the FTC Franchise Rule should be revised; conducted workshops in various locations throughout the country; received hundreds of written comments responding to the FTC's inquiries; consulted with officials who administer state franchise disclosure laws (principally through interface with the NASAA Franchise Project Group); and, internally consulted FTC attorneys, accountants, economists and other experts.

The FTC Staff Report issued this past August is the last administrative act required of the Commission prior to its adoption of a revised FTC Franchise Rule. It consists of 271 pages of text and another 137 pages of exhibits.

—David Kaufmann

Staff Report on the Proposed
REVISED FTC FRANCHISE RULE

Released August 25, 2004

Text of Report
Exhibits
Analysis of Report

ABOUT THIS REPORT

The Federal Trade Commission released this Staff Report on its Franchise Rule, entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," on August 25, 2004. The Report sets forth the staff's recommendations to the Commission on the various proposed amendments to the Franchise Rule. The Commission has not reviewed or approved the Report. Comments on the Staff Report will be accepted through November 12, 2004.

The Commission has engaged in an ongoing effort to amend the Franchise Rule, starting with a review of the Franchise Rule in 1995, followed by the publication of an Advanced Notice of Proposed Rulemaking in 1997 (BUSINESS FRANCHISE GUIDE ¶ 11,122) and the publication of a Notice of Proposed Rulemaking in 1999 (BUSINESS FRANCHISE GUIDE ¶ 11,713). This Staff Report summarizes the rulemaking record to date, analyzes the various alternatives, and sets forth the staff's recommendations as to the form of the final revised Franchise Rule.

Written comments should be identified as "Franchise Rule Staff Report" and sent to the Secretary, FTC, Room H-159 (Annex W), 600 Pennsylvania Ave., N.W., Washington, D.C. 20580. The FTC recommended that comments filed in paper form should be sent by courier or overnight services, since U.S. postal mail in the Washington area and at the FTC is subject to delay due to heightened security precautions. Comments can also be filed electronically at the following website: https://secure.commentworks.com/ftc-franchisereport. All comments will be placed on the public record and will be available for public inspection on normal business days from 8:30 a.m. to 5 p.m., in Room 130 at the above address.

ACKNOWLEDGEMENT

The Publisher thanks David J. Kaufmann, of Kaufmann, Feiner, Yamin, Gildin & Robbins, New York, for his analysis that immediately precedes the Staff Report.

HIGHLIGHTS AND ANALYSIS OF FTC STAFF REPORT DETAILING FORTHCOMING REVISED FRANCHISE RULE

By David J. Kaufmann*

INTRODUCTION

On August 25, 2004, the Federal Trade Commission's Bureau of Consumer Protection issued its Staff Report to the Federal Trade Commission and Proposed *Revised Trade Regulation Rule—Disclosure Requirements and Prohibitions Concerning Franchising* (the "Staff Report"), which sets forth the FTC staff's suggestions as to how the FTC Franchise Rule[1] should be revised for the first time since it was promulgated in 1979, along with the text of the proposed successor Rule.

The Federal Register Notice announcing the Staff Report, issued on September 2, 2004, provides that comments on the proposals outlined in the Staff Report will be accepted through November 12, 2004. Comments filed in paper form should be delivered (in person or, in lieu of U.S. mail, by overnight courier if possible) to: Federal Trade Commission, Office of the Secretary, Room H-159 (Annex W), 600 Pennsylvania Avenue, N.W., Washington, D.C. 20580. Comments may be filed electronically at the following website: https://secure.commentworks.com/ftc-franchisereport. At that site you can also find a copy of the Federal Register Notice and the Staff Report.

The Staff Report does not indicate when the Federal Trade Commission will move to adopt the revised Franchise Rule appended thereto (as the proposal may be further modified following the aforementioned comment period).

The Staff Report is a visionary and remarkable accomplishment, reflecting a dedicated commitment to ascertain in detail the current status of franchising; its role in the American economy; the needs, wants and desires of franchising's "players" (franchisors, franchisees, those professionals who serve them and the public at large); and a commitment to address and incorporate the vast demographic, economic, societal and technological changes which have transpired since the promulgation of the current FTC Franchise Rule in 1979.

Franchising owes a sincere debt of gratitude to those responsible for aggregating the Staff Report — Eileen Harrington (FTC Associate Director, Division of Marketing Practices); Steven Toporoff (FTC Franchise Program Coordinator); and, J. Howard Beales III (Director, FTC Bureau of Consumer Protection).

In this report, we will examine the methodology that gave rise to the Staff Report and proposed revised FTC Franchise Rule; examine their provisions; and offer analysis as to how the suggested revised Rule will alter the current disclosure paradigm and otherwise impact franchising.

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* Mr. Kaufmann is senior partner of New York City's Kaufmann, Feiner, Yamin, Gildin & Robbins LLP, which represents many of our nation's largest and most prestigious franchisors. Mr. Kaufmann authored New York's franchise statute, the New York Franchise Act; is an advisor to the organization of state and federal officials responsible for devising and coordinating franchise regulatory activity nationwide (the North American Securities Administrators Association Franchise Project Group); has been nominated to serve on the Governing Committee of the American Bar Association Franchise Forum; is Past Chair of the New York State Bar Association Franchise Law Committee; appears in McKinney's New York Statutes as an expert on franchising; serves as the New York Law Journal's franchise columnist and as Executive Editor of LJN Franchising Business & Law Alert; chairs all Practising Law Institute programs on franchising nationwide; and served as Special Deputy Attorney General of New York assigned to the Franchise Section of that office.

[1] *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, 16 CFR § 436.

BACKGROUND AND METHODOLOGY

Following years of proposals, hearings and comments, the Federal Trade Commission promulgated its Franchise Rule in 1979. The Rule has remained unchanged since then, while franchising grew in exponential terms and came to be a major force in the American economy (with some reports suggesting that today 40% of all retail sales in the United States are consummated at franchised outlets). The FTC thus undertook a regulatory review of the Franchise Rule in 1995, seeking public comment on whether there was a continuing need for the Rule and, if so, how the Rule could be improved in view of the massive economic and societal changes which transpired following the Rule's adoption in 1979.

Over the past nine years, the Commission published various rulemaking notices seeking comment on proposed Rule modifications; conducted workshops in various locations throughout the country; received hundreds of written comments responding to the Commission's inquiries and advancing suggestions as to how the Franchise Rule should be revised; consulted with officials who administer state franchise registration and disclosure statutes (principally through interface with the NASAA Franchise Project Group) and internally consulted FTC attorneys, accountants, economists and other experts.

The FTC Staff Report is the last administrative act required of the Commission prior to its adoption of a revised FTC Franchise Rule. It consists of 271 pages of text and another 137 pages of exhibits (including the text of the proposed revised FTC Franchise Rule).

FTC FRANCHISE RULE TO BE MAINTAINED — BUSINESS OPPORTUNITIES TO BE SEPARATELY REGULATED

An essential issue addressed by the FTC over the past decade was whether the Franchise Rule continued to serve a useful purpose and should thus be retained or, in the alternative, whether it now served no useful purpose and should be discarded.

Comments received by the FTC overwhelmingly supported maintenance of the FTC Franchise Rule as a cost-effective means of providing material information to prospective franchisees. However, the Staff Report proposes that the Franchise Rule — which also subsumes and governs the offer and sale of business opportunities — now be confined to franchising alone, with the Commission addressing business opportunity sales separately in a subsequent rulemaking endeavor.

FORTHCOMING FTC RULE WILL NOT REGULATE THE FRANCHISOR/ FRANCHISEE RELATIONSHIP

The suggestion forthcoming from many franchisee advocates that the revised FTC Franchise Rule govern franchisor-franchisee relationships is soundly rejected by the Staff Report.

Instead, the Staff Report observes that franchise relationships are private, contractual matters that are regulated at the state level; that the Commission has received no evidence that establishes that franchise relationships are legally "unfair"; that franchise purchases are entirely voluntary such that injuries to franchisees can reasonably be avoided; and that, accordingly, the Commission has no authority to engage in a far-reaching rulemaking that would regulate the substantive terms of private franchise contracts.

UFOC DISCLCOSURE MODEL ADOPTED — CURRENT FTC FRANCHISE DISCLOSURE FORMAT ABANDONED

The current FTC Franchise Rule provides its own format for the disclosure document that the Rule mandates be furnished to prospective franchisees prior to the offer or sale of any franchise — a format that is distinctly different from the Uniform Franchise Offering Circular ("UFOC") disclosure format required to be used under fifteen state franchise registration/disclosure statutes

While the FTC permits franchisors to utilize the state UFOC disclosure format in lieu of the FTC Rule's own format, the converse does not hold true; that is, the states forbid the use of an FTC Franchise Rule disclosure document to satisfy their disclosure requirements. It is for this reason that the vast majority of franchisors in the United States utilize the UFOC disclosure format, as it fulfills all federal and state disclosure requirements.

In recognition of this, and in an attempt to lessen unnecessary inconsistencies between federal and state franchise disclosure laws, the Staff Report recommends that the forthcoming revised FTC Franchise Rule abandon the current Rule's disclosure format and instead require franchisors to exclusively utilize the UFOC disclosure format — but with modifications that would result in additional (and some modified) disclosures from those currently mandated under the UFOC Guidelines (which, under the aegis of NASAA, and as adopted by each franchise-regulating state, contains the instructions for preparing a UFOC disclosure document). For this reason, many in the franchise community refer to the disclosure requirements of the forthcoming revised FTC Franchise Rule as "UFOC plus."

While CCH intends to issue a comprehensive report following the FTC's adoption of its revised Franchise Rule, comprehensively detailing the precise manner in which disclosure under the forthcoming Rule will vary from current UFOC Guideline requirements, those variations proposed in the Staff Report may be summarized as follows:

Item 1 — The Franchisor and Any Parent, Predecessors and Affiliates: A franchisor's corporate "parent" must now be disclosed — but not that parent's prior business history (unless that parent sells franchises or provides products or services to franchisees). Further, franchisors must disclose any competition that franchisees may experience from any business in which an officer of the franchisor owns an interest.

Item 2 — Business Experience: No disclosure of brokers will be required under the suggested revised Franchise Rule, in stark contrast to the UFOC Guidelines. Although franchisors need not disclose officers of their corporate parents generally, they will have to disclose any parent corporate officer who exercises management responsibility relating to the sale or operation of franchises offered under the subject disclosure document. Also to be disclosed are any other executives — even though not officers, directors or partners of the franchisor — who will have management responsibility relating to the franchises being offered for sale.

Item 3 — Litigation: Material actions commenced by franchisors against their franchisees involving the franchise relationship over the past year must be disclosed on an annual basis (no interim updating necessary); franchisors must disclose corporate parent litigation if the parent guarantees the franchisor's performance; litigation involving an affiliate offering franchises under the franchisor's principal trademark must be disclosed; any government litigation against an affiliate that has offered or sold franchises in any line of business within the past ten years must be disclosed; disclosure of confidential settlements will be mandated, as under the UFOC Guidelines, but limited for start-up franchisors to those entered into after the franchisor began franchise sales activity; and, "grouping" of litigation disclosures (such as under common headings) will be permitted.

Item 4 — Bankruptcy: Disclosure of franchisor's corporate parent's bankruptcy history required.

Item 5 — Initial Fees: No variation from UFOC Guidelines.

Item 6 — Other Fees: Franchisors for the first time will be required to disclose all required payments made directly to third parties, and then state either the amount or range of the subject payments or, if unknown, "[t]he amount of the fee is unknown and may vary depending upon factors, such as the third party supplier selected."

Item 7 — Estimated Initial Investment: No variation from UFOC Guidelines.

Item 8 — Restrictions on Sources of Products and Services: Franchisors must disclose any third party supplier in which a franchisor's officer owns an interest.

Item 9 — Franchisee's Obligations: No variation from UFOC Guidelines.

Item 10 — Financing: No variation from UFOC Guidelines.

Item 11 — Franchisor's Assistance, Advertising, Computer Systems and Training: Summary disclosure of required computer equipment and systems permitted, in contrast to UFOC Guidelines (which require more detailed disclosure).

Item 12 — Territory: Disclosure required not only about competition from outlets within a prospective franchisee's intended territory or adjacent to a prospective franchisee's location, as currently required under the UFOC Guidelines, but also of any competition to be forthcoming from franchisor activities over the Internet, through catalog sales, telemarketing or through other alternative channels of distribution. Further, disclosure beyond the UFOC Guidelines would be required regarding restrictions on the franchisee from conducting business outside of his or her territory. In addition, the following admonition will be required for franchisors which do not offer protected territories: "You will not receive an exclusive territory. You may face competition from other franchisees or franchisor-owned outlets, or from other channels of distribution or competitive brands that we control."

Item 13 — Trademarks: No variation from UFOC Guidelines.

Item 14 — Patents, Copyrights and Proprietary Information: No variation from UFOC Guidelines.

Item 15 — Obligation to Participate in the Actual Operation of the Franchise Business: No variation from UFOC Guidelines.

Item 16 — Sales Restrictions: No variation from UFOC Guidelines.

Item 17 — Renewal, Termination, Transfer and Dispute Resolution: Current UFOC tabular disclosure regarding "renewal" must contain a statement as to what the term "renewal" means for the subject franchise system and, if applicable, a statement that franchisees may be asked at renewal to execute a form of franchise agreement with different terms and conditions than their expiring agreements. Examples of the required renewal explanations to be set forth in forthcoming FTC Franchise Rule Compliance Guide to be promulgated by FTC.

Item 18 — Public Figures: No variation from UFOC Guidelines.

Item 19 — Financial Performance Representations: Disclosure of financial performance information (formerly known as "earnings claims") will not be mandatory but, as under UFOC Guidelines, will remain strictly optional. Information regarding a franchisee's prospective costs or expenses, standing alone, will not constitute a "financial performance representation"; franchisors will be free to disclose to prospective franchisees such expense or cost information even in the absence of any Item 19 disclosure. Two mandatory disclosures not contained in the UFOC Guidelines would be required under the proposed revised Franchise Rule — the first confirming that the Franchise Rule permits franchisors to disclose financial performance information in their disclosure documents if they desire (a requirement designed to counter what the FTC views as a widespread falsehood utilized by certain errant franchisors that the Rule actually forbids the dissemination of such information) and, if the subject disclosure document does not contain Item 19 financial performance representations, then a second required disclosure specifically stating this fact and warning prospective franchisees not to rely on any unauthorized financial performance representations they may otherwise receive.

Item 20 — Outlets and Franchisee Information: Five separate tables summarizing the status of a franchisor's network will be required (addressing the number of units in a franchisor's system; number of transfers over the past three fiscal years; turnover rate of

"double counting" problem extant under the UFOC Guidelines (i.e., when a single franchise has been terminated, reacquired by the franchisor and thereafter refranchised, the UFOC Guidelines requires the sequence to be disclosed as three distinct events) is eliminated through the Rule's utilization of a "last event in time" approach. Franchisors would have to disclose their use of "confidentiality clauses" prohibiting franchisees from discussing with prospective franchisees the former's experiences in the franchise system, and would also have to disclose all franchisee associations that the franchisor endorses or supports, as well as independent associations which are incorporated and ask to be included in the disclosure document.

Item 21 — Financial Statements: Subfranchisors' financial statements would be required to be set forth in all instances (under the UFOC Guidelines, such financial statements must only be incorporated when the subfranchisor is the applicant for franchise registration). Parent financial statements must be incorporated in the disclosure document only if the parent commits to fulfill post-sale obligations on behalf of the franchisor or guarantees the obligations of the franchisor (and, if so, a copy of any such parent guarantee must be set forth in the disclosure document). Financial statements must be prepared in accordance with United States generally accepted accounting principles ("GAAP") unless otherwise permitted by the Securities and Exchange Commission (a provision that would permit foreign franchisors to utilize non-GAAP financial statements so long as they reconcile them to United States GAAP through footnotes and explanations). A three year phase-in of audited financial statements for start-up franchisors would still be permitted, but not for spin-offs, affiliates or subsidiaries of a franchisor that has either engaged in franchising in the past or otherwise prepared audited financial statements for any other purpose.

Item 22 — Contracts: No variation from UFOC Guidelines.

Item 23 — Receipt: No variation from UFOC Guidelines.

ELECTRONIC DISCLOSURE

Clearly one of the most visionary aspects of the proposed revised Franchise Rule is its authorization for franchisors to engage in "pure" electronic disclosure.

Under the suggested Rule, franchisors could satisfy their obligation to furnish disclosure documents to prospective franchisees if the document is hand delivered; e-mailed; accessed on the Internet (so long as the franchisor previously furnished directions to prospective franchisees as to how to do so); or mailed to the prospective franchisee in either paper or tangible electronic form (i.e., computer disk or CD-ROM) by first class U.S. mail at least three days before the required disclosure date.

If electronic disclosure is employed, the franchisor's disclosure document must be in a form that permits each prospective franchisee to store, download, print or otherwise maintain the document for future reference, and no electronic enhancements — such as audio, video, other multimedia, pop-up screens or external links — may be utilized. However, navigational tools (such as scroll bars), internal links and search features to enhance a prospective franchisee's ability to maneuver through an electronic disclosure document will be permitted.

Before electronic disclosure is utilized, the franchisor must advise the prospective franchisee of any prerequisites for electronically obtaining the disclosure document (such as any computer software necessary to view the document).

To complete the protocol, the revised Rule would permit Item 23 receipts to be executed electronically or otherwise evidenced through the use of security codes, passwords or similar authenticating means.

TIMING OF DISCLOSURE

The current FTC Franchise Rule "disclosure trigger" timing requirements — preemptive over all state franchise laws — will be supplanted by an entirely new protocol if the Rule is revised as the Staff Report recommends.

Under the current Rule, a franchisor must furnish its disclosure document to a prospective franchisee at the earlier of: (i) the "first personal meeting" between a franchisor and such prospective franchisee, or (ii) ten business days prior to (a) the execution by the prospective franchisee of any franchise or franchise-related agreement, or (b) the payment by such prospect of any monies or other consideration to the franchisor. As well, the current Rule requires that a copy of the franchise agreement to be entered into by the parties, in a form ready for execution by them, be furnished to the prospective franchisee at least five business days prior to the date of execution.

Under the revised Rule, the "first personal meeting" disclosure trigger is eliminated, as is the "ten business day" trigger for disclosure documents and the "five business day" trigger for franchise agreements. Instead, the revised Rule will simply require franchisors to furnish their disclosure documents to prospective franchisees fourteen days (not business days) before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or its affiliate.

Gone altogether is the general requirement that a franchisor furnish any franchise or franchise-related agreement in a form ready for execution to its prospective franchisee five business days (or, indeed, at any time) prior to the franchisee's execution thereof. Instead, only if the franchisor has unilaterally and materially altered the terms and conditions of the standard franchise or other agreement attached to its disclosure document will that franchisor be required to furnish an "execution ready" copy of that agreement to its prospective franchisee (in such limited circumstances, seven calendar days prior to the franchisee's execution thereof). Negotiated changes to a franchisor's standard form of franchise agreement will not trigger this limited franchise agreement disclosure requirement, as such contracts would not be unilaterally altered by the franchisor but, instead, would contain changes prompted by franchisee request.

New disclosure triggers are added by the proposed revised Rule beyond those found either in the current FTC Franchise Rule or in any state franchise registration and disclosure statute.

First, the revised Rule would require franchisors to furnish copies of their disclosure documents to prospective franchisees upon reasonable request earlier in the sales process than is otherwise required by the Rule. Further, for the first time in franchise regulation history, a franchisor would be obligated to engage in disclosure in connection with a franchisee's sale of his/her franchised unit to a third party transferee in circumstances where the franchisor had no involvement in such transaction other than to approve or disapprove the transfer. Specifically, the revised Rule would require franchisors in such an event to furnish to prospective purchasers of existing franchised outlets any "existing disclosures" upon the prospective franchisee's reasonable request.

Lastly, the revised Rule would oblige franchisors to redisclose with their most recent disclosure documents (and any updates thereto) any prospective franchisees who are in the sales cycle, upon such franchisees' reasonable request.

RULE INAPPLICABLE TO INTERNATIONAL TRANSACTIONS

The revised Rule would expressly limit its jurisdictional reach to the sale of franchises that will be located in the United States of America, its territories and possessions. This critical clarification resolves an open issue presented by the current FTC Franchise Rule, which is silent on the subject (a silence which has given rise to some disparate judicial decisions regarding international applicability of the Rule).

Mirroring the UFOC Guidelines — which were amended in 1993 inter alia to require that disclosure documents be prepared in "plain English" — the proposed revised Franchise Rule imposes the same requirement.

WHO IS RESPONSIBLE FOR EFFECTING DISCLOSURE

Under the revised Rule, it is only and always the franchisor that bears ultimate responsibility for ensuring that prospective franchisees receive disclosure documents. Franchise brokers will no longer have that responsibility, as they do under the current Rule.

Subfranchisors under the revised Rule will have their own distinct disclosure obligations. First, they will be responsible for furnishing disclosure to prospective franchisees in the same manner as franchisors. Moreover, the disclosure document they disseminate must include all required information about the franchisor and, to the extent applicable, the same information concerning the subfranchisor.

WHO MAY RECEIVE DISCLOSURE

Since the beginning of franchise regulation over thirty years ago, the requirement under federal and state law has always been that franchise disclosure documents must be furnished to the "prospective franchisee."

The revised Rule would dramatically change this paradigm, however, by authorizing delivery of the disclosure document to a franchisee's representative (attorney, accountant or other advisor) in lieu of the franchisee himself/herself/itself.

LIABILITY FOR CONTENTS OF DISCLOSURE DOCUMENTS

The current FTC Franchise Rule does not specifically address who is responsible for the contents of a franchise disclosure document; it only specifies who is liable for furnishing disclosure.

The revised Rule eliminates this void by expressly denominating those who bear liability for any violation of the revised Rule's requirements governing the contents of a franchisor's disclosure document — both the franchisor itself and any other "franchise seller" who either directly participated in any violative conduct or had the "authority to control" such conduct.

Since the term "franchise seller" is defined by the revised Rule to include a franchisor's "employees, representatives, agents, subfranchisors and third party brokers who are involved in franchise sales activities," the above-referenced liability provisions of the revised Rule may inadvertently snare all senior officers of a corporate franchisor, since they technically could be deemed to have the "authority to control" the contents of their companies' franchise disclosure documents — even though they were never aware of, did not know of, should not have known of and had utterly no responsibility for those disclosure documents. The larger the franchisor, the greater the possibility that this result will pertain.

We trust that the Commission will address this issue prior to its promulgation of the final revised Rule.

DISCLOSURE REQUIRED OUTSIDE OF DISCLOSURE DOCUMENT

Toward the end of both the Staff Report and the revised Rule is a provision that could have substantial impact upon the scope of a franchisor's disclosure obligations and the interplay between the revised FTC Franchise Rule and state franchise registration and disclosure statutes.

Specifically, Section 436.10(a) of the revised Rule (as appended to the Staff Report) states in its second sentence: "... (F)ranchisors may have additional obligations to disclose material information to prospective franchisees under Section 5 of the Federal Trade Commission Act." No such provision is found in the current FTC Franchise Rule.

In explaining this provision, the Staff Report states:

> This does not mean that a franchisor must include other material information in its disclosure document. *Indeed, the prohibition against including additional materials, other than non-preempted state law requirements, would bar a franchisor from expanding its disclosures to include even additional material information. Rather, a franchisor might be compelled under Section 5 (of the FTC Act) to disclose information to a prospective franchisee separately from the disclosure documents* (emphasis added).

The difficulties engendered by this new Rule provision and the Staff Report commentary may prove quite significant. Virtually every state franchise registration and disclosure statute requires that franchise disclosure documents contain all material facts — while the above-quoted provisions of the proposed revised Rule suggest that such material information, if not delineated in the Rule as subject to disclosure, may *not* be incorporated in such disclosure documents, but instead must be disclosed to prospective franchisees separate and apart from disclosure documents.

To complicate matters, neither the revised Rule nor the Staff Report offers any guidance as to what form such separate disclosures must take, whether the timing requirements of the revised Rule would pertain to such disclosures, or what disclosures in fact must be effected (the revised Rule does not define the term "material"), leaving franchisors in the dark as to what this new Rule provision actually requires.

We believe that the issues engendered by the above-referenced revised Rule provision will be properly synthesized when the final Rule is promulgated.

UPDATING DISCLOSURES

The proposed revised Franchise Rule, as is the case under the current Rule, mandates that all information in a franchisor's disclosure document be current as of the close of the franchisor's most recent fiscal year. However, the revised Rule would afford franchisors 120 days (rather than the current 90 days) in which to prepare their revised disclosure documents.

Also identical to the current Rule's mandate is the revised Rule's "quarterly update" requirement.

The revised Franchise Rule contains no general continuing update requirement compelling franchisors to revise their disclosure documents to reflect material changes to the facts set forth therein. The only exception pertains to Item 19 financial performance representations (if any). If a franchisor becomes aware of material changes regarding same, then the revised Rule would require franchisors to notify their prospective franchisees. Notably, the revised Rule does not specify how these "material changes" to Item 19 information are to be furnished to prospective franchisees — by means of a revised core disclosure document or outside of that disclosure document (through separate writings or other communications).

The revised Rule's protocol of having franchisors delay incorporating material changes to the information contained in their disclosure document until the Rule's required quarterly updates clashes with state franchise law requirements that such material changes require franchisors to cease offering and selling franchises and instead amend their disclosure documents to reflect such changes. We trust that the final version of the revised FTC Franchise Rule will address this disparity.

EXEMPTIONS

The FTC Franchise Rule currently affords very few exemptions or exclusions from its coverage. Today, exemptions or exclusions from FTC Rule coverage exist for only "fractional franchises"; leased departments; franchise relationships requiring the payment of $500 or less before or within six months after commencement of operation of the franchisee's

franchise relationship; employment relationships; cooperative associations; and single trademark license agreements.

The revised Rule affords a number of broad exemptions from disclosure — and note in this regard that, while many state franchise disclosure statutes provide exemptions from registration which parallel the following revised Rule exemptions, not a single one of them exempts franchisors from engaging in disclosure.

The revised Rule maintains the "$500 minimum payment," fractional franchise and leased department exemptions afforded by the current FTC Franchise Rule, and provides for the following exemptions as well: (i) franchise relationships covered by the Petroleum Marketing Practices Act; (ii) "large investment" transactions (where the franchisee's estimated investment, excluding financing or monies received from the franchisor or its affiliates, and further excluding any real estate costs, totals at least $1 million); (iii) a "sophisticated franchisee" exemption (available if the prospective franchisee is an entity that has been in business for at least five years and has a net worth of at least $5 million); and (iv) situations where one or more purchasers of at least a 50% ownership interest in the franchise within sixty days of the sale has been, for at least two years, an officer, director, general partner, or individual with management responsibility for the franchisor's franchise sales program or the administration of its network, or has been an owner of at least a 25% interest in the franchisor.

PROHIBITIONS

In addition to all of the current prohibitions of the current FTC Franchise Rule, the revised Rule would add a number of new ones.

First, franchisors would be prohibited from utilizing "shills" in the franchise sales process by misrepresenting that any person actually purchased or operated one of the franchisor's franchises, or could otherwise provide an independent and reliable report about the franchise or the experiences of any current or former franchisees, when, in fact, such was not the case.

Further, the revised Rule would forbid a franchisor from disclaiming, or requiring a prospective franchisee to waive reliance on any representation made in that franchisor's disclosure document. However, the revised Rule provides an exception from this prohibition with respect to franchisees who voluntarily waive specific contract terms and conditions in the course of contract negotiations. Interestingly, the revised Rule does not expressly restrict such negotiations to franchise agreement terms that are either as favorable or more favorable to the franchisee than those disclosed in the franchisor's disclosure document. This leaves open the possibility (at odds with all state franchise registration and disclosure statutes, and judicial decisions construing same) that the forthcoming revised Rule may permit franchise negotiations that result in greater franchisee obligations than those specified in the disclosure document to transpire without triggering any redisclosure requirement.

As well, the revised Rule would make it a violation of Section 5 of the Federal Trade Commission Act for any franchisor to fail to furnish a copy of its disclosure document to a prospective franchisee upon reasonable request earlier in the sales process than is otherwise required by the revised Rule; fail to furnish updated disclosure documents to prospective franchisees who are in the "pipeline" upon request; fail to furnish existing disclosures to a prospective purchaser of an existing franchised outlet upon request; or present for execution a franchise agreement which contains terms and conditions materially different from those set forth in the contract appended to the disclosure document (unless the franchisor informs the prospective franchisee of the differences seven days before execution).

PREEMPTION

As is currently the case, the revised Rule would provide that it does not intend to preempt the franchise laws of any state except to the extent of any inconsistency with the revised Rule (and a state law would not be deemed inconsistent with the Rule if it afforded prospective franchisees equal or greater protection, such as registration of disclosure documents or more extensive disclosures).

However, as observed earlier in this report, the revised Rule would expand upon, and add to, the current Uniform Franchise Offering Circular Guideline disclosure requirements mandated by the states, creating a new disclosure floor with which all franchisors must comply. The Staff Report expresses its desire " . . . that NASAA and the states would adopt the revised Rule, further reducing inconsistencies between federal and state law." But despite this gentle expression of normative desire, it would appear that the above-quoted preemption language of the revised Franchise Rule would, in fact, mandate that the states require the expanded UFOC information required by the revised FTC Franchise Rule.

As well, many of the more striking features of the revised FTC Franchise Rule — first and foremost "pure" electronic disclosure — have no analogues in extant state franchise registration and disclosure statutes. While clearly such Rule provisions not addressing disclosure document contents have no preemptive effect upon the franchise regulating states, nevertheless it would be disconcerting if the more visionary aspects of the Franchise Rule were not adopted by them, for that would relegate these salutary new Rule features for use only in the 35 states which have no franchise registration and disclosure statutes and are thus governed solely by the FTC Franchise Rule.

The ability of the states that do have franchise registration/disclosure statutes to incorporate the new "UFOC plus" disclosure mandates of the proposed revised FTC Franchise Rule is complicated by the fact that, while many require only regulatory amendments to do so (relatively easily accomplished within a reasonable period of time), nine such states (Hawaii, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, South Dakota, and Wisconsin) have franchise laws that delineate in the statutes themselves what disclosures must be effected by franchisors (with some amplifying these requirements in regulations). At least some of those states — those which have no amplifying disclosure regulations — must effect any adoption of the revised Rule's disclosure requirements through the enactment of statutory amendments by state legislatures.

Clearly, the harmonization of the new disclosure "floor" created by the proposed revised FTC Franchise Rule and the current disclosure requirements of states featuring franchise registration and disclosure statutes will prove a daunting and complicated task. However, in stark contrast to certain other sectors, the government officials responsible for federal and state franchise law administration have historically proven remarkably cooperative and diligent in their efforts to harmonize federal and state franchise regulation in a collegial and effective manner.

CONCLUSION

The Staff Report and proposed revised FTC Franchise Rule are visionary and expansive, subsuming no less a mission than evolving the federal regulation of franchising in the United States to reflect the transformation of that critical component of the American economy over the past quarter century and the changes in society, demographics, economics and technology since the current FTC Franchise Rule was first promulgated in 1979.

Any comments regarding the proposed revised FTC Franchise Rule will be accepted only through November 12, 2004 and may be filed as detailed at the outset of this report.

AMERICAN BAR ASSOCIATION
27TH ANNUAL FORUM ON FRANCHISING

FTC DEVELOPMENTS AFFECTING FRANCHISING

HIGHLIGHTS AND ANALYSIS OF FTC STAFF REPORT ON FORTHCOMING REVISED FRANCHISE RULE ISSUED AUGUST 25, 2004 (Supplemental Handout)

David J. Kaufmann
Kaufmann, Feiner, Yamin, Gildin & Robbins LLP
New York, New York

and

Judith M. Bailey
Gust Rosenfeld PLC
Phoenix, Arizona

October 6 - 8, 2004
The Sheraton Wall Centre Hotel
Vancouver, British Columbia

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HIGHLIGHTS AND ANALYSIS OF FTC STAFF REPORT DETAILING FORTHCOMING REVISED FRANCHISE RULE

I. INTRODUCTION

On August 25, 2004, the Federal Trade Commission's Bureau of Consumer Protection issued its *Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule - - Disclosure Requirements and Prohibitions Concerning Franchising* (the "Staff Report") detailing the Bureau's recommendations to the Commission as to how the FTC Franchise Rule[1] should be revised in a wholesale fashion for the first time since its promulgation in 1979. Attached to the Staff Report is the text of the successor FTC Franchise Rule (the "Revised Rule") which the staff recommends the Commission adopt.

If the FTC Franchise Rule is ultimately revised as suggested by the Staff Report (and it almost certainly will be, perhaps with some minor modifications following the brief comment period provided in the Staff Report – see below), the regulation of the offer and sale of franchises in the United States will undergo the most dramatic transformation since the enactment of federal and state disclosure laws and regulations in the 1970's and 80's.

The Staff Report is a work of stunning achievement. Global in its vision, the report reflects extraordinary depth of intellect; a thorough understanding of the centrality, impact and import of franchising to the United States economy; and, a remarkable effort to ascertain and, as prudent, incorporate in the Staff Report the desires, needs and policy positions both of franchisors who will be regulated by the forthcoming revised FTC Franchise Rule and franchisees whose interests are sought to be protected and advanced thereunder. All of us in franchising owe a great debt of gratitude to those responsible for commissioning and authoring the Staff Report - - Eileen Harrington (FTC Associate Director, Division of Marketing Practices); Steven Toporoff (FTC Franchise Program Coordinator); and, J. Howard Beales III (Director, FTC Bureau of Consumer Protection).

The revised FTC Franchise Rule which the Staff Report recommends the Commission adopt vastly improves upon the proposals for Rule revision set forth in the Commission's prior rulemaking notice, the 1999 FTC Notice of Proposed Rulemaking ("NPR"). Clearly, the Commission and its staff have paid great heed to the hundreds of comments received following the NPR's promulgation. Equally clear is the Commission's stated interest in resolving any remaining ambiguities either directly in the revised Rule itself or in the forthcoming "FTC Franchise Rule Compliance Guide" which the Staff Report indicates will accompany promulgation of the final Rule. We thus are most confident that, while some issues (as identified below) may yet require some "fine tuning" before final Rule adoption, the Commission's demonstrated proclivity to capture a broad universe of input and make changes in response will yield a final revised FTC Franchise Rule which will serve the franchise industry extraordinarily well over the coming decades.

In this paper, we shall detail the methodology which the FTC staff utilized in preparing the Staff Report; examine each substantive change to be wrought if the Commission adopts the revised FTC Franchise Rule as recommended the Staff Report; analyze how current Uniform Franchise Offering Circular ("UFOC") disclosure documents would have to be modified to

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[1] *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, 16 CFR 436.

comply with the mandates of the proposed revised Franchise Rule; and, address regarding the preemptive effective of the revised FTC Franchise Rule.

For those interested in reviewing the complete text of the Staff Report, a press release with a link to the report is available at the Commission's website: **www.ftc.gov**.

II. BACKGROUND/FTC METHODOLOGY

The FTC Franchise Rule took effect in 1979 against a backdrop of widespread fraud and criminality in the franchise arena.

As modern franchising exploded on the scene in the 1950's and 60's, widespread press accounts about franchisors and franchisees growing wealthy in this burgeoning arena quickly attracted the attention of the criminal community, including organized crime. Tens of thousands of people nationwide collectively lost hundreds of millions of dollars to criminal franchise enterprises - - enterprises which, utilizing slick brochures and outright fraud, sold phantom, non-existent franchises to hapless victims. Indeed, so bad was the situation that even *60 Minutes* did a "take down" piece on franchising featuring a scam perpetrated by an outfit known as "Wild Bill's Family Restaurants" (the principals of which ultimately were indicted by a federal grand jury).

The states responded first and took the lead in fighting franchise fraud, with California enacting the first ever "franchise specific" statute – the California Franchise Investment Law[2] – in 1971 (pursuant to which a franchisor has to register itself and its franchise disclosure document, and distribute that document to prospective franchisees prior to accepting any money or signing any contract, lest the franchisor expose itself to both criminal and civil liability). Other key states enacted parallel legislation over the ensuing decade (Maryland[3], Virginia[4], Wisconsin[5], Illinois[6], Minnesota[7], Indiana[8], New York[9], North Dakota[10], South Dakota[11], Michigan[12], Hawaii[13], Oregon[14], Washington[15] and Rhode Island[16]).

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[2] California Franchise Investment Law, California Corporations Code, Div. 5, Parts 1-6, Section 31000 *et. seq.*

[3] Maryland Franchise Registration and Disclosure Law, Ann. Code of Maryland, Business Regulation, Title 14, Section 14-201 *et. seq.*

[4] Virginia Retail Franchising Act, Virginia Code, Title 13.1, Ch. 8, Section 13.1-557 *et. seq.*

[5] Wisconsin Franchise Investment Law, Wisconsin Stats., Ch. 553, Section 553.01 *et. seq.*

[6] Illinois Franchise Disclosure Act, Illinois Compiled Statutes, Ch. 815, Section 705/1 *et. seq.*

[7] Minnesota Statutes, Ch. 80C, Section 80C.01 *et. seq.*

[8] Indiana Code, Title 23, Article 2, Ch. 2.5, Section 1 *et. seq.*

[9] New York General Business Law, Art. 33, Section 680 *et. seq.*

[10] North Dakota Franchise Investment Law, North Dakota Century Code Ann., Title 51, Ch. 51-19, Section 51-19-01 *et. seq.*

[11] South Dakota Franchises for Brand-Name Goods and Services Law, South Dakota Codified Laws, Title 37, Ch. 37-5A, Section 37-5A-1 *et seq.*

[12] Michigan Franchise Investment Law, Michigan Compiled Laws, Ch. 445, Section 445.1501 *et. seq.*

[13] Hawaii Franchise Investment Law, Hawaii Rev. Stat.,Title 26, Ch. 482E, Section 482-E1 *et seq.*

[14] Oregon Franchise Transactions Law, Oregon Revised Statutes, Title 50, Ch., 650, Section 650.005 *et. seq.*

[15] Washington Franchise Investment Protection Act, Revised Code of Washington, Title 19, Ch. 19.100, Section 19.100.010 *et. seq.*

The same year that California enacted its franchise statute, the Federal Trade Commission announced the initiation of a proceeding for the promulgation of a trade regulation rule relating to disclosure requirements and prohibitions concerning franchising.[17] Public hearings were held, statements and comments received, a proposed rule published in 1974 and, ultimately, today's FTC Franchise Rule was adopted and took effect in 1979. Pursuant to the FTC Franchise Rule, franchisors are required to make full pre-sale disclosure prior to the offer or sale of any franchise through a disclosure document the format for which is specifically delineated in the Rule[18] and in the FTC's "Interpretative Guides" promulgated thereunder.[19]

Critically, the fifteen states which had enacted franchise registration and disclosure laws refused to accept an FTC format disclosure document thereunder, instead demanding compliance with each such statute's designated disclosure format. To eliminate the "patchwork quilt" confusion engendered by these varying (and sometimes conflicting) state disclosure requirements, the state franchise administrators – originally acting under the umbrella of the Midwest Securities Commissioner's Association and acting today under the umbrella of the North American Securities Administrators Association ("NASAA") – in the mid-1970's developed the "Uniform Franchise Offering Circular" (better known as the "UFOC"), a disclosure document format which – when prepared in accordance with NASAA's UFOC Guidelines[20] and when accompanied by certain addenda – would satisfy the disclosure requirements of all franchise-regulating states.

To facilitate legal disclosure compliance by national or regional franchisors confronting two varying disclosure formats -- one federal, one state – the FTC permitted franchisors to utilize the UFOC disclosure format in lieu of the FTC's own disclosure format.[21]

The Rule remained unchanged since its promulgation in 1979, prompting the Commission in 1995 to conduct a regulatory review of the Franchise Rule[22] seeking public comment on whether there was a continuing need for the Rule and, if so, how to improve the FTC Franchise Rule in light of the massive industry, societal, economic and technological changes which transpired following the Rule's adoption in 1979. In response to this notice, the Commission received 75 written comments and held two public workshops at which fifty individuals participated (the "Rule Review").[23]

Following the Rule Review, the FTC determined to amend the Franchise Rule and, to that end, published an Advanced Notice of Proposed Rulemaking ("ANPR")[24] seeking comment on several proposed Rule modifications, including creating a separate trade regulation for business opportunity sales (subsumed under the current FTC Franchise Rule); revising the Rule's disclosure requirements to mirror those required by the states under the UFOC

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[16] Rhode Island Franchise and Distributorship Investment Regulations Act, General Laws of Rhode Island, Title 19, Ch. 28.1, Section 19-28.1-1 *et. seq.*

[17] 36 Fed. Reg. 21607 (November 11, 1971).

[18] 16 CFR § 436.1.

[19] *Interpretative Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 FR 49966, August 24, 1979.*

[20] CCH Bus. Franchise Guide ¶ 5750.

[21] *FTC Interpretative Guides, supra.*, § I(D)(1).

[22] 60 Fed. Reg. 17,656 (April 7, 1995).

[23] *Staff Report* at 2.

[24] 62 Fed. Reg. 9115 (February 28, 1997).

Guidelines; limiting the Rule's application to the sale of franchises situated within the United States, its territories and possessions; and, permitting electronic disclosure.

In response to the Commission's publication of the ANPR, the Commission received 166 written comments and held six public workshop conferences at which 65 individuals participated (including franchisors, franchisees, state regulators and consultants).[25]

The next step in the Franchise Rule's amendment process was the Commission's publication of a Notice of Proposed Rulemaking ("NPR") in October, 1999.[26]

Attached to the NPR was a proposed revised Franchise Rule, a detailed discussion of each proposed Rule revision and an invitation for the public to submit comments and, if deemed desirable, request a public hearing (no one requested such a hearing). The FTC received forty comments in response to the NPR.

The last administrative act required of the Commission prior to its adoption of a revised Franchise Rule is the promulgation of the Staff Report addressed herein.[27] The Staff Report consists of 271 pages of text and another 137 pages of exhibits (including the text of the proposed revised FTC Franchise Rule).

III. FTC FRANCHISE RULE TO BE MAINTAINED AND REVISED

In accordance with federal administrative requirements, a core issue presented by the FTC's ANPR was whether the Franchise Rule continued to serve a useful purpose and should thus be retained or, in the alternative, now served no useful purpose such that it should be discarded.[28]

The Staff Report reveals that the record overwhelmingly supported maintenance of the FTC Franchise Rule as a cost-effective way to provide material information to prospective franchisees so they may assess the costs, benefits and potential risks involved in entering into a franchise relationship.[29] However, as presaged in the ANPR, the Staff Report proposes that the FTC Franchise Rule (which, despite this shorthand nomenclature, actually governs both the sale of franchises and business opportunity ventures) be confined to franchising alone, with the Commission addressing business opportunity sales through a separate rulemaking process.[30] If this recommendation is adopted (and it almost certainly will be), the current Rule's business opportunity governance provisions, and the Commission's enforcement of them, will continue until a new business opportunity regulation is promulgated.[31]

So it is that if the proposed revised Franchise Rule is enacted as suggested by the Staff Report, it will be confined exclusively to franchising.

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[25] *Staff Report* at 2-3.

[26] 64 Fed. Reg. 57, 294 (October 22, 1999).

[27] FTC Rules of Practice, § 1.13(f).

[28] 62 Fed. Reg. at 9,120.

[29] *Staff Report* at 6.

[30] *Staff Report* at 12.

[31] *Staff Report* at 13, f.n. 42.

IV. NO REGULATION OF THE FRANCHISOR-FRANCHISEE RELATIONSHIP

Despite strident calls by franchisees and their advocates that the revised Franchise Rule address what some of them term post-sale "abusive franchise relationships", the Staff Report makes clear that the forthcoming revised Franchise Rule will do no such thing.

Specifically, franchisees urged the FTC to have the forthcoming revised Franchise Rule prohibit the enforcement of franchise agreement post-term covenants not to compete; franchisors' "encroachment" of franchisees' "market territories"; and, restrictions on franchisee sourcing of products and services, among other practices.[32] Indeed, some franchisees asserted that if the forthcoming revised Rule could not address post-sale relationship issues, then the Commission should abolish the Rule altogether.[33]

The suggestion that the forthcoming revised FTC Franchise Rule govern franchisor-franchisee relationships is soundly rejected in the Staff Report:

> ...(T)here is little doubt that some franchisees are dissatisfied with their franchise purchase... (But) the Commission lacks the statutory ability to broaden the Rule to address post-sale franchise relationship issues. As an initial matter, franchise relationships are private, contractual matters that are regulated at the state level.
>
> The evidence in the ongoing rulemaking proceeding fails to establish that post-sale franchise relationships are legally "unfair", as defined above (in Section 5 of the FTC Act). There is no question that the record reveals that some franchisees have suffered harms in the course of operating their franchises. However, we have no basis to quantify the level of harm. Specifically, we cannot determine how much of the injury is attributable to actions taken by the franchisor, by franchisees, or to other factors, such as downturns in the economy or shifting consumer preferences... Further, we have no basis to conclude that any such injuries to individual franchisees outweigh countervailing benefits to the public at large or to competition.
>
> Most important, in many instances, injury to franchisees can reasonably be avoided. A franchise purchase is entirely voluntary. Prospective franchisees can avoid harm by comparison shopping... Prospective franchisees are also free to discuss the nature of the franchise system with existing and former franchisees. Under the circumstances, the Commission can hardly conclude that prospective franchisees who voluntarily enter into franchise agreements after receiving full disclosure nonetheless cannot reasonably avoid harm resulting from a franchisor enforcing the terms of the franchise agreement.
>
> As a result, the Commission has no authority to engage in a far-reaching rulemaking that would mandate the substantive terms of all private franchise contracts.[34]

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[32] *Staff Report* at 7.

[33] *Staff Report* at 7, f.n. 27, citing American Franchisee Association ("Our members feel so strongly about the Commission's inability to deal with substantive issues of concern to them, they would rather work to abolish the FTC rule then suffer the abuses of both a government agency *and* their franchisors").

[34] *Staff Report* at 8-10.

Nevertheless, the Staff Report indicates that information about the state of franchisor-franchisee relationships is material and that more disclosure is warranted to ensure that prospective franchisees understand the quality of that relationship before they commit to purchasing a franchise. Toward that end, the Staff Report recommends that the revised Franchise Rule expand certain pre-sale disclosures to address relationship issues (*i.e.*, the existence of trademark-specific franchisee associations and certain litigation commenced by franchisors against their franchisees and similar such disclosures[35], as detailed hereafter).

V. UFOC DISCLOSURE MODEL ADOPTED/FTC FRANCHISE RULE DISCLOSURE FORMAT ABANDONED

As noted earlier, the current FTC Franchise Rule provides its own format for the disclosure document which the Rule mandates be furnished to prospective franchisees prior to the offer or sale of any franchise. Also as noted, the FTC permits franchisors to utilize the state ordained UFOC disclosure format in lieu of the FTC Rule's disclosure format.

However, the converse does not hold true. That is, with few exceptions, the fifteen states having franchise registration and disclosure laws on their books forbid the use of an FTC Franchise Rule formatted disclosure document to satisfy state disclosure obligations.

So it is that the vast majority of franchisors in this country utilize the UFOC disclosure format, since it satisfies all federal and state disclosure requirements.

Understanding this; striving to reduce unnecessary inconsistencies between federal and state franchise disclosure laws; and, noting that uniformity between federal and state franchise laws will help facilitate "comparison shopping" among franchise systems by prospective franchisees, the Staff Report recommends that the forthcoming revised FTC Franchise Rule abandon the current Rule's disclosure format and instead require franchisors to utilize exclusively the UFOC disclosure format, but with a twist - - the revised Franchise Rule would layer on additional disclosure requirements (and some modified disclosure requirements) from those currently required under the UFOC Guidelines. It is for this reason that many in the franchise community refer to the disclosure requirements of the forthcoming revised FTC Franchise Rule as "UFOC plus."

The precise manner in which the FTC Franchise Rule, if revised as recommended in the Staff Report, will vary from the UFOC Guidelines is addressed on an item-by-item basis in the chart entitled, "Comparison of UFOC and Proposed FTC Franchise Rule Disclosure Requirements" annexed hereto as Attachment A.

In furtherance of this new disclosure scheme, the proposed revised Franchise Rule incorporates much of the UFOC Guidelines' substantive text and instructions (varied as necessary to comport with the forthcoming Franchise Rule's "UFOC plus" disclosure requirements). However, purely explanatory materials in the UFOC Guidelines and NASAA's Commentaries thereto are not incorporated in the proposed revised Rule – instead, the Staff Report indicates that accompanying the revised Rule will be a "Compliance Guide" promulgated by the Commission where various disclosure issues will be addressed at length (said Compliance Guide analogous to the FTC's "Final Interpretative Guides" for the current FTC Franchise Rule).[36]

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[35] *Staff Report* at 11.

[36] *Staff Report* at 14.

VI. ELECTRONIC DISCLOSURE

Clearly one of the most visionary aspects of the Staff Report, and one which addresses not only the recent technological revolution but seeks to capture as well developments which will surely follow, is the Staff Report's recommendation that the revised Franchise Rule permit "pure" electronic disclosure (in contrast to the electronic disclosure paradigm suggested in the FTC's NPR a few years ago, under which electronic disclosure would be permitted only if a prospective franchisee consented in advance and was furnished with a paper summary document containing an expanded cover page, table of contents and acknowledgement of receipt[37]).

Under the proposed revised Franchise Rule, franchisors could satisfy their obligation to furnish disclosure documents to prospective franchisees if the document is hand delivered; e-mailed; accessed on the Internet (provided the franchisor furnishes directions to the prospective franchisee regarding how to do so by the required disclosure date); or, by mailing to the prospective franchisee a paper or tangible electronic copy (*i.e.*, computer disk or CD-ROM) by first class U.S. mail at least three days before the required disclosure date.[38]

Under this electronic disclosure paradigm, a franchisor's electronic disclosure document must be in a form that permits each prospective franchisee to store, download, print or otherwise maintain the document for future reference, a provision designed to ensure that prospective franchisees can review the document at will; retain a copy for future reference; and, share it with their advisors.[39]

Further, to ensure the integrity of disclosure documents, the proposed revised Franchise Rule will prohibit franchisors from using any electronic enhancements – such as audio, video, other multimedia, pop-up screens and external links – which a franchisor could utilize to call attention to favorable portions of its disclosure document or distract prospective franchisees from damaging disclosures. However, franchisors engaging in electronic disclosure under the revised Rule would be authorized to utilize navigational tools (such as scroll bars, internal links and search features) to enhance a prospective franchisee's ability to maneuver through an electronic disclosure document.[40]

One element of the electronic disclosure protocol detailed in the Staff Report and the proposed revised Franchise Rule annexed thereto is certain to prompt attention, the requirement that: "Before furnishing a disclosure document, the franchisor shall advise the prospective franchisee of the formats in which the disclosure document is made available, any prerequisites for obtaining the disclosure document in a particular format, and any conditions necessary for reviewing the disclosure document in a particular format."[41] This new directive, not previously raised in the FTC's NPR, is designed to supplant the NPR's "prior consent" requirement (under which electronic disclosure could be effected only with the prior consent of the prospective franchisee) and, according to the Staff Report, is meant to ensure that

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[37] 64 Fed. Reg. at 57,316 – 57,317.

[38] *Revised Rule*, § 436.2(c).

[39] *Revised Rule*, § 436.6(a).

[40] *Staff Report* at 211-214 and *Revised Rule*, § 436.6(c).

[41] *Revised Rule*, § 436.6(f).

prospective franchisees know whether or not they will receive a disclosure document in a form they can easily use.[42]

Under this requirement:

> A franchisor would disclose if it furnishes disclosures, for example, via CD ROM only. In addition, the franchisor must disclose if there are any special conditions to reviewing a disclosure document. For example, the franchisor would disclose whether the prospective franchisee's computer must be capable of reading pdf files or whether any specific applications are necessary to view the disclosures (such as Windows 2000 or DOS, or a particular Internet browser).[43]

We surmise given the FTC's visionary and enlightened adoption of a pure electronic disclosure protocol, insisting on a paper "format disclosure" document is not what it has in mind. Instead, we surmise that a franchisor will be able to communicate its disclosure format information in any fashion it chooses – in person; telephonically; in writing; through e-mail; and, in its franchise application forms, marketing materials or otherwise - - so long as, for its own benefit, the franchisor is able to prove that, in fact, it effected "format disclosure."

Finally, pure electronic disclosure would be obviated if, as today, a franchisor would have to obtain a manually signed receipt from each prospective franchisee acknowledging his/her/its receipt of the subject franchise disclosure document. Accordingly, while the proposed revised Franchise Rule, like the UFOC Guidelines, requires an Item 23 "Receipt" form and further requires franchisors to retain copies of signed receipts for each completed franchise sale effected over at least the prior three years,[44] the revised Rule would now define the term "signature" as including "...a person's handwritten signature, as well as a person's use of security codes, passwords, electronic signatures, and similar devices to authenticate his or her identity."[45]

Thus, under the revised Franchise Rule, franchisors would be free to capture franchisee disclosure document receipts electronically – but clearly must also take steps to retain proof of such electronic receipts not only for Rule compliance but as a defense to any litigation claim that disclosure was not properly effected.

VII. TIMING OF DISCLOSURE

The revised Rule eliminates entirely the "disclosure trigger" timing requirements of the current Rule, substituting instead a simplified timing requirement – but adding new disclosure triggers as well.

Under the current Rule – preemptive in this regard over analogous state franchise registration and disclosure statutes – a franchisor must furnish its disclosure document to a prospective franchisee at the earlier of: (i) the "first personal meeting" between a franchisor and such prospective franchisee (*i.e.*, the first face-to-face meeting held for the purpose of discussing the sale, or possible sale, of a franchise), or (ii) ten business days prior to the

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[42] *Staff Report* at 216.

[43] *Id.*

[44] *Revised Rule*, §436.6(h) at 63.

[45] *Id.*, § 436.1(u) at 6.

execution by the prospective franchisee of any franchise or franchise-related agreement or the payment by such prospect of any monies or other consideration to the franchisor.[46]

As well, the current Rule requires that a copy of the franchise agreement be entered into by the parties, in a form ready for execution by them, be furnished to the prospective franchisee at least five business days prior to the date of execution.[47]

Reflecting the Commission's NPR observation that "...the first personal meeting trigger is obsolete in a communications age where prospective sellers now communicate with buyers through a wide array of communications media, including facsimile machine, e-mail and the Internet," as well as the NPR's observation that the current Rule's "ten business day" requirement may be unnecessarily confusing (because federal holidays are excluded thereunder, some of which are not observed in every state), the Staff Report and revised Rule instead provide that franchisors will be required to furnish their disclosure documents to prospective franchisees fourteen days (not business days) before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or its affiliate.[48]

This "bright line" disclosure trigger, suggests the Staff Report, will eliminate guesswork on the part of franchisors regarding when they must furnish disclosures. And to eliminate prospective confusion as to how to count the required fourteen days, the Staff Report makes clear that the forthcoming FTC Franchise Rule Compliance Guide will specify that the fourteen days commences the day after delivery of the disclosure document, such that the signing of any agreement or receipt of payment can take place fifteen days later (thus guaranteeing prospective franchisees a full fourteen days to review the disclosures).[49]

Scrapped altogether in the proposed revised Rule is any general requirement that a franchisor furnish any franchise or franchise-related agreement in a form ready for execution to its prospective franchisee at any time prior to the execution thereof. The Staff Report observes that the logic underlying the current Rule requirement – providing time to study the franchise agreement – is already served by the Rule's basic disclosure requirement that every disclosure document append a copy of the franchisor's basic agreement, changes to which most likely arise at the franchisee's initiation, hardly warranting redisclosure. Further, the Staff Report contends that the current Rule's contract furnishing requirement may actually hinder a franchisee's ability to negotiate changes to a franchise agreement, since the delay inherent in the mandatory contract review period may discourage negotiations if a prospective franchisee believes that he or she will suffer as a result of such delay.[50]

Which is not to say that the proposed revised Rule does not contain any requirement that a franchisor furnish to its prospective franchisee an "execution ready" copy of any franchise or franchise-related agreement. It does, but under a very limited circumstance – that in which the franchisor has unilaterally and materially altered the terms and conditions of its standard contract attached to its disclosure document. Under such circumstances, a franchisor would be required to furnish an "execution ready" copy of the subject agreement to its prospective franchisee seven calendar days prior to franchisee execution. This requirement would exclude situations where the only difference between the standard contract and the execution contract

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[46] 16 CFR §§ 436.1(a) and 436.2(g).

[47] Id. at § 436.1(f).

[48] *Staff Report* at 78; *Revised Rule*, § 436.2 at 7.

[49] *Staff Report* at 78.

[50] *Staff Report* at 80-82.

are "fill in the blank" provisions, such as the date, name and address of the franchisee and/or deviations from the franchisor's standard contract initiated at the prospective franchisee's request.[51]

While the revised Rule thus eliminates the contract disclosure trigger (except in limited circumstances) and simplifies the disclosure document dissemination trigger, it also adds new disclosure obligations and triggers currently not found either in the FTC Franchise Rule or in any state franchise registration and disclosure statute.

First, the revised Franchise Rule would require franchisors to furnish copies of their disclosure documents to prospective franchisees upon reasonable request earlier in the sales process than is otherwise required by the Rule.[52] The Staff Report avers that this requirement will preclude situations where prospective franchisees must expend considerable monies before receiving any disclosure about the subject franchisor:

> For example, a franchisor might encourage a prospect to fly across the country to visit its headquarters. If the prospective franchisee knew, for example, that the franchisor was involved in significant litigation with its franchisees, or was under a Commission order for fraud, he or she might decline the invitation. We also believe that encouraging a prospect to incur expenses to advance the franchise sale might "hook" or "pre-condition" the prospect, making it more likely that he or she will go through with the deal without a thorough due diligence investigation... We are not suggesting that a franchisor must tender a disclosure document to any consumer who may desire a copy. Rather, this prohibition would apply where the parties have already conducted specific discussions or negotiations or otherwise taken steps to begin the sales process.[53]

Another new disclosure trigger fostered by the proposed revised Rule would, for the first time in franchise regulation history, require franchisors to engage in disclosure during the franchise transfer process (that is, in connection with the sale, assignment or other disposition of an existing franchise by a current franchisee) – even in circumstances where the franchisor was not entering into any new agreement with the transferee and had no involvement in the transaction other than to approve or disapprove the proposed transfer. This requirement is extant neither in the current FTC Franchise Rule nor in any state franchise registration and disclosure statute.

Specifically, proposed Section 436.9(f) of the revised Rule would make it an unfair or deceptive act or practice for a franchisor to "(f)ail to furnish existing disclosures to a prospective purchaser of an existing franchised outlet, upon reasonable request."

The Staff Report justifies the imposition of this new requirement by observing:

> ...(W)e recognize that an argument can be made that all prospective transferees should be entitled to the benefits of pre-sale disclosure in order to make an informed investment opportunity. However, we would not go that far. For example, a franchisor may have stopped selling franchises when an existing franchisee decides to sell his or her unit. If so, it would be unreasonable to compel a franchisor to incur the costs of creating a disclosure document solely to

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[51] *Staff Report* at 82 and *Revised Rule* § 436.2(b).

[52] *Revised Rule*, § 436.9(e) at 264.

[53] *Staff Report* at 63, 77.

assist an existing franchisee in selling his or her unit. Rather, we believe that a better approach would to be to create a new prohibition barring franchisors from failing to furnish a prospective transferee with a copy of an existing disclosure document upon reasonable request.[54]

A number of difficulties may arise from this new disclosure requirement. First, this disclosure obligation could result in franchisors judicially being held liable (or jointly liable) for any fraud, misrepresentation, omission or other illegality attendant to a franchisee's sale of its franchise to a third party where the franchisor had no involvement other than to approve or disapprove the transfer. Under the current Rule, franchisors not directly involved in such franchisee transfer transactions (other than to register their approval or disapproval) have no disclosure obligations whatsoever to the prospective transferee,[55] since, as the Staff Report itself observes, "...the purchaser is not relying on any sales representations of the franchisor, but on the terms and conditions spelled out in the existing contract."[56]

Yet by compelling franchisors to inject themselves and their disclosure documents into such transactions, the wisdom of current FTC policy on the issue will be eradicated and, instead, franchisors may find themselves co-defendants in any subsequent action claiming impropriety in the franchise transfer transaction. Especially since the franchisor's disclosure document will often prove misleading to prospective franchise transferees, since that disclosure document is geared to the interests of prospective first time franchisees and accordingly sets forth initial investment, continuing royalty, advertising contribution and a host of other data which may be wholly inapposite to those transferees (especially if the franchisor's current franchise agreement contains payment and other obligations markedly different from the older form of agreement which is the subject of the transfer).

In addition, while the Staff Report (as quoted above) believes it would be unreasonable to compel a franchisor to create a disclosure document solely for the benefit of a franchise transferee, the revised Rule compelling transferee disclosure only states that a franchisor must furnish its "existing disclosures" to a prospective franchisee. The Staff Report elucidates that if a franchisor has ceased selling franchises, then no transferee disclosure obligation would pertain. But what if that franchisor stopped selling franchises everywhere except Hawaii (where it maintained its registration of a current franchise disclosure document) and the franchised unit to be transferred is located in Maine - - conceivably, the revised Rule would require the franchisor to furnish to the prospective Maine transferee a copy of its Hawaii disclosure document, yet further increasing the likelihood of a subsequent fraud claim against the franchisor by the transferee (since, in addition to all of the other possibly inapplicable data in the disclosure document referenced above, we add the twist that all such data is or may be geared to a very different state). Further, posit the difficulty where a franchisor's only "existing disclosure" pertains to a very different type of unit than that which is the subject of the transfer transaction - - an "express" restaurant versus the full "sit down" unit being transferred or a 1,500 room resort hotel vs. the 150 room suburban hotel being transferred. Again, the "existing disclosure" will prove not only inapplicable but misleading to the prospective transferee, engendering possible franchisor liability where none properly should exist.

Conceivably, neither the FTC nor the revised Rule intends for such a result to pertain, since the franchisor in such transfer disclosure scenarios is not a "franchise seller" as that term

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[54] *Staff Report* at 66.

[55] Final Interpretative Guides, 44 Fed. Reg. at 49,969.

[56] *Staff Report* at 65.

is defined by the revised Rule (note, however, that neither is the selling franchisee deemed a "franchise seller" under the revised Rule). Presumably, the goal the Commission hopes to achieve is merely affording transferees the opportunity to review at last some pertinent disclosure (such as the franchisor's litigation and bankruptcy history, its management team and its intellectual property rights) before consummating the transfer transaction. Hopefully, the Commission will further clarify the proposed Rule's new transferee disclosure requirements following the forthcoming comment period.

The proposed revised FTC Franchise Rule continues the Rule's requirement that disclosure be effected to existing franchisees who are renewing their franchises only if the renewal agreement contains terms and conditions that differ materially from the expiring agreement.[57] However, under this Rule provision, the existing franchisee must make a "required payment" for the right to enter into a new franchise agreement for disclosure to become obligatory; merely entering into a new franchise agreement without any required payment, or extending an existing franchise agreement for a fee, would not be deemed a "sale of a franchise" for Rule purposes and thus would not trigger disclosure.[58]

The last new disclosure trigger created by the proposed revised Rule would require a franchisor to furnish its most recent disclosure document (and any updates thereto) to a prospective franchisee who is in the sales cycle upon that prospective franchisee's reasonable request.[59] While we will address later the revised Rule's directives as to when a franchisor's disclosure document must be updated, and such updates furnished to prospective franchisees in the midst of the sales process, suffice it to note here that having to comply with multiple disclosure requests of each prospective franchisee in the "pipeline," and documenting same, can only inadvertently slow down the franchise sales process (each redisclosure presumably comes with its own fourteen day delay before any franchise agreement can be signed or monies paid) while dramatically escalating compliance costs for newer and/or smaller franchisors (with the Staff Report suggesting that such an impact will not inure to larger franchisors, which the Report observes can always simply e-mail or post on their websites such updated disclosure documents).

VIII. RULE INAPPLICABLE TO INTERNATIONAL TRANSACTIONS

The current FTC Franchise Rule is silent on the seminal issue of its applicability to the sale of franchises to be situated outside of the United States – a silence which, in the past, has given rise to some disparate judicial decisions.

In the proposed revised Rule, this confusion is eradicated and the principle made clear: the revised Rule will apply only to the sale of a franchise which will be located in the United States of America, its territories and possessions.[60]

The Staff Report details why this conclusion was reached:

> Nothing in the record to date negates the Commission's tentative findings... that the Rule's disclosure obligations in the international sales context are unnecessary, may be misleading, and may impede competition... (N)one of the

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[57] *Revised Rule*, § 436.1(t).

[58] *Staff Report* at 65, f.n. 222.

[59] *Revised Rule*, § 436.9(g), at 264.

[60] *Revised Rule*, § 436.2, at 7.

commentators have identified specific problems or offered evidence showing that American companies selling franchises internationally engage in fraud or deception... To the contrary, the record strongly supports the view that foreign franchise sales generally involve sophisticated investors who are represented by counsel or who otherwise can protect their own interests. It is also clear that the Commission developed the Franchise Rule in response to problems occurring in the domestic market. There is no evidence in the record that a disclosure document addressing the American market would benefit prospective investors operating overseas. Just the opposite appears to be true: such disclosures may be irrelevant and potentially misleading when applied to a foreign franchise purchase due to the vast differences between American and foreign markets, cultures and legal systems.[61]

Moreover, notes the Staff Report, to be relevant, a franchisor arguably would have to prepare individual disclosure documents tailored to each specific foreign market, placing American franchisors at a competitive disadvantage.

IX. USE OF "PLAIN ENGLISH" MANDATED

Mirroring the UFOC Guidelines – which were amended in 1993 *inter alia* to require that disclosure documents be prepared in "plain English"[62] – the proposed revised Franchise Rule imposes the same requirement.

Specifically, Section 436.6(a) of the revised Rule contains the mandated "plain English" requirement, with that phrase defined to mean:

> ...The organization of information and language usage understandable by a person unfamiliar with the franchise business. It incorporates the following six principles of clear writing: short sentences; definite, concrete, everyday language; active voice; tabular presentation of information; no legal jargon or highly technical business terms; and no multiple negatives.[63]

As is currently the case under all state franchise laws and the extant FTC Franchise rule, the revised Rule imposes no "plain English" requirement upon the franchise or franchise-related agreements which may or will be entered into.

X. FINANCIAL PERFORMANCE REPRESENTATIONS (f/k/a "EARNINGS CLAIMS")

As the Staff Report notes, one of the most important disclosure mandates of the proposed revised Franchise Rule pertains to Item 19, addressing the making of financial performance representations (historically referred to as "earnings claims").

In this instance, perhaps the most critical element of the proposed Rule's treatment of the subject is what the Rule does not say – it does not require franchisors to present financial performance representations of any type or nature in their disclosure documents. Instead, as has historically been the case since the dawn of franchise regulation, franchisors under the revised Rule would have the option of presenting financial performance representations in Item 19 of their disclosure documents if they so elect, but in no fashion would be compelled to do so.

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[61] *Staff Report* at 73-74.

[62] See *UFOC Guidelines*, General Instruction 150.

[63] *Revised Rule*, § 436.1(o).

> Based upon the record, the staff continues to recommend that financial performance representations remain voluntary. In reaching this conclusion, we recognize that false or misleading financial performance claims represent the most common allegation in Commission franchise law enforcement actions. However, there is no assurance that mandating performance claims will in fact reduce the level of false claims. Indeed, a mandated financial performance requirement might have the unintended effect of forcing honest franchisors to disclose financial information that they believe is unreasonable, incomplete, or inaccurate, while doing little to deter franchisors bent on misrepresenting their performance history. No new data, policies or arguments have been raised... that would lead us to a different conclusion. Accordingly,... we are persuaded that financial performance representations should remain voluntary, consistent with the current Rule and UFOC Guidelines.[64]

The revised Rule would, however, would radically alter in certain respects the fashion in which franchisors could disseminate financial performance representations to prospective franchisees.

First, revised Item 19 would eliminate the current Rule's requirement that franchisors furnishing financial performance representations provide prospective franchisees with a separate document containing those representations. Instead, any financial performance claims and their substantiation would appear in the text of the disclosure document.

In addition, the definition of "financial performance information" has been changed to more closely mirror the comparable UFOC Guidelines' definition, so that both historic and projected financial performance information is captured and the use of charts, tables and mathematical calculations imparting or subsuming such information embraced.[65]

In a dramatic policy shift, the proposed revised Rule abandons the current Rule's requirement that geographic relevance pertain to any financial performance representation made to a prospective franchisee, making the revised Rule's disclosure requirements consistent with the UFOC Guidelines.[66]

As well, in a material change, the revised Rule eliminates the current Rule's requirement that a franchisor furnishing financial performance information compare the number of franchisees who have performed at the claimed level against all franchisees in its system, not just against franchisees it has measured or against franchisees in a defined subgroup.[67] Instead, the revised Rule permits franchisors to disclose financial performance information about one or more subgroups of existing franchisees, provided that the information: (a) has a reasonable basis; (b) the franchisor discloses the nature of the universe of outlets measured (that is, what particular set of characteristics they share - - geographic location, freestanding vs. shopping center, degree of competition in the market area, length of time the outlets have operated, services or goods sold, whether the outlets are franchised or franchisor-owned and operated, or other such distinguishing characteristics); (c) the precise dates of the reported financial performance information are set forth; (d) the franchisor discloses the total number of outlets that existed in the relevant period and, if different, the number of outlets that had the

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[64] *Staff Report* at 162.

[65] *Revised Rule*, § 436.1(e).

[66] *Staff Report* at 162-163.

[67] *Id.* at 163.

above-described subset characteristics; (e) the disclosure document specifies the number of subgroup outlets whose actual financial performance data were used in arriving at the financial performance representation and the number and percent that actually attained or surpassed the stated results; and, (f) disclosure is made regarding any characteristics of the subset universe of outlets, such as the characteristics identified above, that may differ materially from those of the outlet being offered to a prospective franchisee.[68]

"(W)e are convinced that the geographic relevance requirement, coupled with the requirement that franchisors disclose number and percentage data based upon all of their outlets, is unnecessarily restrictive, preventing franchisors from sharing material, truthful performance information about subgroups of existing franchisees", notes the Staff Report. "Our recommendation to eliminate the geographic relevance requirement and revise the disclosures for subgroups will remove obstacles to making financial performance data available to prospective franchisees... In addition, these provisions will better ensure that prospects do not draw unreasonable inferences by requiring franchisors to disclose the material differences between the subgroup units tested and the units being offered."[69]

The revised Rule abandons the Commission's current requirement that historical financial performance data be prepared according to generally accepted accounting principles ("GAAP").[70] "...(W)e are convinced that the GAAP requirement is unnecessary and may impede franchisors' ability to disclose performance information, to the detriment of both franchisors and prospective franchisees," asserts the Staff Report.[71] Instead, franchisors making historical financial performance representations will have the flexibility under the revised Franchise Rule to formulate such representations however they wish, provided that they are reasonable and that the franchisor can satisfy its burden of establishing such reasonableness.[72]

As before, financial projections (as opposed to historical financial performance information) prepared in compliance with American Institute of Certified Public Accountants ("AICPA") standards for financial forecasts will be presumed to be reasonable, a policy to be memorialized in the forthcoming FTC Franchise Rule Compliance Guide.[73]

In a critical move – one which will place the forthcoming revised Franchise Rule at odds with the current UFOC Guidelines – the revised Rule excludes from its definition of "financial performance representation" a franchisor's disseminating to prospective franchisees expense or cost information alone (a move actually supported by NASAA during the comment process[74]). For years, both franchisors and prospective franchisees have been frustrated by the legal inability to convey cost or operating expense information to prospective franchisees absent the making of a full financial performance disclosure in Item 19 of the disclosure document. Now, the revised Rule would remove that obstacle and permit franchisors to disseminate to prospective franchisees some of the information they most strongly desire – cost and operating expense information.

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[68] *Revised Rule*, § 436.5(s)(3).

[69] *Staff Report* at 165.

[70] 16 CFR §§ 436.1(c)(4) and 436.1(e)(2).

[71] *Staff Report* at 166.

[72] *Id.* at 167.

[73] *Id.* at 167, f.n. 535.

[74] *Staff Report* at 28.

"...(W)e are persuaded that expense information alone is insufficient to enable prospects to gauge their potential earnings with any degree of specificity", observes the Staff Report. "Therefore, when compared with gross or net revenue data, for example, expense information is not likely to mislead prospective franchisees about their potential success or risk in purchasing a franchise."[75] Further, to avoid any confusion that a franchisor's dissemination of cost disclosures in items 5 – 7 of the disclosure document (initial fees/continuing payment obligations/initial investment) do not constitute the making of a financial performance representation, the Staff Report recommends that a statement to that effect appear in the forthcoming FTC Franchise Rule Compliance Guide.[76]

The revised Franchise Rule's Item 19 disclosure protocol will require franchisors to include certain specified preambles in their disclosure documents – one if they make financial performance representations in Item 19 and two if they do not.

The first preamble confirms that the Franchise Rule permits franchisors to disclose financial performance information in their disclosure documents, a requirement designed to counter what the FTC views as a widespread falsehood utilized by errant franchisors that the FTC Franchise Rule actually forbids the dissemination of financial performance information.[77] This preamble would also inform prospective franchisees that any financial performance information they receive which differs from that included in Item 19 of their franchisor's disclosure document may be given only if: (i) the franchisor is furnishing the actual records of an existing outlet the prospective franchisee is considering purchasing, or (ii) the franchisor is supplementing information contained in Item 19 of its disclosure document (for example, by providing information about performance at a particular location or under particular circumstances).[78]

The second required preamble would, under the revised Rule, have to follow the above-referenced preamble in any disclosure document that does not set forth financial performance representations. Geared to preclude prospective franchisees from relying on unsubstantiated financial performance representations, that preamble reads as follows:

> 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.[79]

Retained in the revised Rule is the current requirement that franchisors making financial performance representations admonish prospective franchisees that their individual performance results may differ.[80] Also carried forward is the current Rule requirement that a

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[75] *Id.* at 28.

[76] *Id.* at 28.

[77] *Id.* at 167.

[78] *Revised Rule*, § 436.5(s).

[79] *Id.* at § 436.5(s)(2).

[80] *Id.* at § 436.5(s)(3)(iv).

statement appear in Item 19 that substantiation of any financial performance representation will be made available to the prospective franchisee upon reasonable request.[81]

Franchisors will be free to disclose to prospective franchisees the actual operating results of a specific unit(s) being offered for sale without complying with the forthcoming Franchise Rule's Item 19 disclosure requirements, provided that such information is furnished only to prospective purchasers of that outlet. A franchisor furnishing financial performance information in Item 19 of its disclosure document may supplement that representation outside of the disclosure document with information about a particular location or variation from the representations contained in the disclosure document.[82]

One possible difficulty with the revised Rule's treatment of financial performance representations concerns its retention of the notion that financial performance representations made in the "general media" fall within the embrace of Item 19 requirements, restrictions and prohibitions (requiring identification of the universe of outlets under consideration, relevant dates of representation, number and percentage of outlets of the measured universe that actually attained or surpassed the stated results, characteristics of the included outlets, and so forth). Clearly, it would be hard to argue that advertisements soliciting prospective franchisees should be so restricted. However, both under the current and proposed revised FTC Franchise Rule, "general media" claims are deemed to include not only advertising but also statements made in speeches or press releases.[83] As is the case today, the Commission proposes to except from this "general media" definition, "communications to financial journals or the trade press in connection with bona fide news stories...", as well as communications made directly to lenders in connection with arranging financing for a franchisee.[84] The Staff Report states that these exemptions will be set forth in the forthcoming FTC Franchise Rule Compliance Guide.[85]

This broad definition of "general media" has caused, and if maintained in the final Franchise Rule will continue to cause, difficulty for franchisors. For it subjects them to liability for financial performance information disseminated by franchisor executives in speeches, press interviews or other forums not specifically geared to the franchise sales process unless such financial performance information appears in their companies' disclosure documents. Consider whether the policy instead should be that such information should only be characterized as "financial performance representations" if it appears in oral or written statements given by franchisor executives that are specifically or primarily designed to influence a prospective franchisee's investment decision, lest an enormous chilling effect and vast liabilities attach to the ordinary business conduct of addressing business audiences and granting interviews the general press (as opposed to the "financial journals or trade press" which, as noted above, the Commission exempts).

After all, as the Commission itself notes in its Staff Report:

> ...(T)he Staff has previously advised that the dissemination of financial data through bona fide news stories may generate benefits to the public that outweigh potential harm to prospective franchisees. For example, such information may be useful to potential suppliers seeking growing businesses as customers;

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[81] *Id.* at § 436.5(s)(3)(v).

[82] *Id.* at § 436.5(s)(4) – (v).

[83] *Final Interpretative Guides*, 44 Fed. Reg. at 49,984 – 85 and *Staff Report* at 30-31 and f.n.120.

[84] *Id.*

[85] *Staff Report* at 31.

> shopping center or mall developers seeking promising franchise systems as tenants; and, financial analysts who follow market or industry trends. Accordingly, the exemption from the general media earnings claims disclosure requirements (for financial journals and, per the revised Rule, Internet content not specifically targeted to prospective franchisees) ensures that the Rule does not chill the free flow of newsworthy information about franchising or particular franchise systems.[86]

It was on this basis that the FTC exempted from Rule coverage the dissemination of financial performance representations to "financial journals or the trade press". But the question remains – why should franchisor executives not be free to similarly aid those sectors of the public referenced above by giving interviews to *USA Today*, *CNN* or the *New York Times.*

We suggest that a more logical approach would be to permit franchisors and their executives to disseminate such information in the general media freely – but subject such representations to the restrictions and requirements of the forthcoming revised FTC Franchise Rule only if memorializations of same are later used to influence a prospective franchisee's investment decision (*i.e.*, by means of the franchisor duplicating the published or broadcast representations and furnishing them to prospective franchisees).

Finally, the proposed revised Rule would continue a disclosure requirement related to financial performance information extant today neither in any state franchise registration/disclosure statute nor the UFOC Guidelines – the requirement that franchisors, when furnishing a disclosure document, "...notify the prospective franchisee of any material changes that the seller knows or should have known occurred in the information contained in any financial performance representation made in Item 19."[87] While the Staff Report notes that the current FTC Franchise Rule requires franchisors to notify franchisees at the time they furnish disclosure documents of any material changes to the information contained therein[88], and per force do so outside of the disclosure document, we must confess that, to our knowledge, few if any franchisors pay heed to this requirement. Instead, as we observe it, franchisors whose disclosure documents contain financial performance information that has materially changed almost universally amend those documents to reflect the updated information, and do not convey any such changes outside of the document in any fashion (for to do so could constitute a violation of state franchise registration and disclosure statutes).

Yet that is precisely what the revised Franchise Rule would have franchisors do – furnish updated financial performance information outside of the disclosure document. Many will view this is as a dangerous practice and one which may be viewed as inconsistent with the UFOC Guidelines and the edicts of thirteen state franchise registration and disclosure statutes which specifically require franchisors to amend their disclosure documents upon the occurrence of any material change to the information contained therein.

As will be noted hereafter – see "Updating Requirements" below – the difficulty addressed herein is only one of several associated with the revised Rule's edicts concerning when and under what circumstances a franchisor must (or need not) update its disclosure document.

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[86] *Staff Report* at 31, f.n.119, citing FTC Advisory 97-5, Bus. Franchise Guide (CCH) ¶ 6485 at 9687 (July 31, 1997).

[87] *Revised Rule*, § 436.7(d).

[88] 16 CFR § 436.1(d)(2) and 436.1(e)(6).

XI. WHO IS RESPONSIBLE FOR EFFECTING DISCLOSURE

Under the current FTC Franchise Rule, franchisors and franchise brokers they engage are jointly and severally liable for furnishing disclosure documents to prospective franchisees.[89]

Under the proposed revised Franchise Rule, however, it is the franchisor alone that retains ultimate liability for ensuring that prospective franchisees receive disclosure documents as required by the Rule. "Given our proposal eliminating the first personal meeting disclosure trigger, we believe it is no longer necessary to retain the broker disclosure liability provision," asserts the Staff Report. "In short, it is the franchisor that always retains ultimate liability for ensuring that prospective franchisees receive disclosures required by the Rule."[90] The Staff Report further asserts that this proposal would also reduce inconsistencies with state franchise registration and disclosure statutes, which generally limit disclosure obligations to the franchisor.

Subfranchisors have their own distinct disclosure obligations under the revised Rule. First, they are responsible for furnishing disclosure to prospective franchisees in the same manner as franchisors otherwise are; this is accomplished by the revised Rule's defining the term "franchisor" as including subfranchisors.[91] Moreover, the revised Rule instructs that the disclosure document to be disseminated by subfranchisors must include all required information about the franchisor and, to the extent applicable, the same information concerning the subfranchisor.[92]

Note, however, that the revised Rule does not define the term "subfranchisor." According to the Staff Report, however, "...subfranchisors are treated the same as franchisors under the Rule in narrow circumstances only: where the subfranchisor steps into the shoes of the franchisor by both granting franchises as well as performing post-sale...obligations,"[93] with the Staff Report proposing to further address subfranchising more fully in the forthcoming FTC Franchise Rule Compliance Guide.[94]

Indeed, the "bright line" for determining whether information regarding brokers, subfranchisors or other third parties must be set forth in franchise disclosure documents turns on this principle, according to the Staff Report. "...(T)he granting of a franchise alone should be insufficient to compel (a) third party broker to disclose information about him or herself, such as prior litigation or bankruptcy", states the Staff Report. "On the other hand, a purported broker may not only sell franchises, but perform on behalf of a franchisor as well (such as providing promised training). In such instances, the broker is essentially a subfranchisor and should be covered the Rule's obligation to make disclosures."[95] It is for this reason that the revised Rule defines the term "franchisor" as meaning: "...any person who grants a franchise and participates in the franchise relationship."

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[89] 16 CFR § 436.1(a). *See also* Final Interpretative Guides, 44 Fed. Reg. at 49,969.

[90] *Staff Report* at 85.

[91] *Revised Rule*, § 436.1(k).

[92] *Revised Rule*, § 436.6(e).

[93] *Staff Report* at 215.

[94] *Id.* at 215 f.n. 698.

[95] *Staff Report* at 51.

Clearly, the forthcoming FTC Franchise Rule Compliance Guide will prove of great assistance in further defining, and delineating among, franchise brokers, subfranchisors and other species of franchise "sellers."

XII. WHO MAY RECEIVE DISCLOSURE

The reader may consider this section oddly titled and hardly necessary since, from the dawn of franchise regulation over thirty years ago, the requirement has always been that a franchise disclosure document be furnished to a prospective franchisee.

Indeed, many questions and some litigation have arisen regarding under what circumstances a "franchisee" has, in fact, been disclosed (for example, when only four out of five partners in a general partnership franchisee receive the disclosure document, the franchisor's disclosure burden has been deemed not fully satisfied by at least one court).

The revised Rule would dramatically change this paradigm, however, by permitting a franchisee's representative to accept delivery of the disclosure document in lieu of the franchisee. "We recognize that in some instances a prospective franchisee can be a corporation or other entity, not an individual," notes the Staff Report. "Thus, delivery in such circumstances can only be made upon a representative. Even an individual may wish to have his or her attorney or other agent receive the disclosures on their behalf, and the Rule should accommodate that possibility."[96]

Accordingly, the Staff Report recommends that the forthcoming FTC Franchise Rule Compliance Guide made clear "...that a representative can accept disclosures on behalf of a prospective franchisee."[97]

XIII. LIABILITY FOR CONTENTS OF DISCLOSURE DOCUMENTS

The current FTC Franchise Rule does not specifically address who is liable for the contents of a franchise disclosure document; it only provides that franchisors and franchise brokers are jointly and severally liable for furnishing disclosures.[98]

The revised Rule supplants this vacuum by expressly denominating those who bear liability for ensuring that the contents of a franchisor's disclosure document are full, complete, truthful and prepared in accordance with the revised Rule's requirements:

> In connection with the offer or sale of a franchise to be located in the United States of America... it is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act:
>
> (d) For any franchisor to fail to include the information and follow the instructions in (the revised FTC Franchise Rule) when preparing the disclosure document to be furnished to a prospective franchisee. Any other franchise seller will be liable for the violations of (the disclosure document preparation and contents requirements of the Rule) if they either directly participated in them or had the authority to control them.[99]

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[96] *Staff Report* at 58.

[97] *Staff Report* at 58 and 83, f.n. 265.

[98] 16 CFR § 436.1(a); *Final Interpretative Guides*, 44 Fed. Reg. at 49,969.

[99] *Revised Rule*, § 436.2(d).

That a franchisor (or, as applicable, a subfranchisor) would be liable under the revised Rule for failing to prepare a disclosure document in that fashion, and containing all of the disclosures, required by the Rule is, of course, hardly surprising.

However, caution must attend the last sentence of Section 436.2(d) of the revised Rule, as quoted above, which imposes liability on other "franchise sellers" if they either participated in or had the "authority to control" a violation of the revised Rule's disclosure document preparation and contents provisions.

Specifically, all senior officers of a corporate franchisor could technically be deemed to have the "authority to control" the contents of their company's franchise disclosure document and – under the above-quoted revised Rule language – could thus automatically assume liability for disclosure content failures that they were never aware of, did not know of, should not have known of and had utterly no responsibility for. Should the revised Rule maintain this provision, such liability would not extend only to FTC enforcement actions but to private actions brought by franchisees under state "little FTC" statutes.

We submit that it is one thing for the revised Rule, as it does in the above-quoted language, to impose liability upon a corporate franchisor's officer for directly participating in a disclosure document content violation (*i.e.*, omissions, misstatements or failures to follow Rule instructions), a liability co-extant with that found under many state franchise registration and disclosure statutes. For example, the New York Franchise Act imposes liability upon any officer, director or management employee "...who materially aids in the act or transaction constituting the violation (of the Act)... It shall be a defense to any action based upon such liability that the defendant did not know or could not have known by the exercise of due diligence the facts upon which the action is predicated."[100]

However, we submit that the revised Rule's "authority to control" language quoted above could (we believe wholly unintentionally) impose liability on the entire panoply of a franchisor's senior management team for disclosure document errors, omissions, misrepresentations or format failures which they did not participate in; knew nothing about; and, given their rank and duties, probably should not have known about. The larger the franchisor, the greater the possibility this result will pertain.

XIV. SCOPE OF REQUIRED DISCLOSURE EXCEEDS THAT SPECIFIED IN RULE/ADDITIONAL DISCLOSURE OUTSIDE DISCLOSURE DOCUMENT POSSIBLY MANDATED

Situated toward the end of both the Staff Report and the revised Rule is a provision which could have substantial impact upon the scope of a franchisor's disclosure obligations.

Specifically, Section 436.10(a) of the revised Rule states in its second sentence: "...(F)ranchisors may have additional obligations to disclose material information to prospective franchisees under Section 5 of the Federal Trade Commission Act". No analogous provision is found either in the current FTC Franchise Rule or in any state franchise registration and disclosure statute.

The Commission's reasoning in adopting this Rule provision is as follows:

> The staff further recommends that the Commission adopt the proposal clarifying that compliance with the Rule's specific disclosure obligations will not shield a

[100] New York Franchise Act, General Business Law of New York, Article 33, § 691(3).

franchisor from other violations of Section 5. In short, a franchisor may violate Section 5 by omitting material information even if the franchisor complies fully with the Rule's specific disclosure requirements... This does not mean that a franchisor must include other material information in its disclosure document. *Indeed, the prohibition against including additional materials, other than non-preempted state law requirements, would bar a franchisor from expanding its disclosures to include even additional material information. Rather, a franchisor might be compelled under Section 5 to disclose information to a prospective franchisee separately from the disclosure documents*[101] (emphasis added).

In a footnote, the Commission staff further addresses the issue, stating that: "Proposed Section 436.10(a) merely reaffirms the current state of the law that franchise sellers may have other obligations under Section 5 of the FTC Act beyond those stated in the Franchise Rule."[102]

The aforementioned Rule provision appears to be similar to the standard of disclosure required under virtually every state franchise registration and disclosure statute – the "10(b)-5" standard[103] which franchisors must observe when preparing their disclosure documents. Under this statutory standard, a franchise disclosure document may not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. A difference, however, is that the franchise regulating states insist that all material facts – whether or not specifically required to be set forth by state franchise laws or regulations – must be contained in franchisors' disclosure documents. In contrast, the Staff Report (as quoted above) suggests that while franchisors may have the identical disclosure obligation, they may not add to a disclosure document anything not specifically required by the revised Rule.

Nevertheless, in light of the FTC staff's expressed desire to reduce inconsistencies between federal and state law, and the staff's recognition that the revised Rule does not preempt non-conflicting state law, we can assume that the Commission would permit franchisors to include additional information in a disclosure document (at least in the franchise registration states) in order to comply with the states prompt updating requirements. Indeed, the revised Rule specifically provides that a franchisor may add to a disclosure document non-preempted information needed to comply with state law.

XV. UPDATING DISCLOSURES

The proposed revised Franchise Rule, with very minor variations, retains the current Rule's mandate as to when a franchisor's disclosure document must be updated.

As is the case under the current Rule,[104] the revised Rule mandates that all information in a franchisor's disclosure document be current as of the close of the franchisor's most recent fiscal year. Whereas the existing Rule affords franchisors only a 90 day period in which to prepare a revised disclosure document, the revised Rule would extend that time to 120 days following the close of the franchisor's fiscal year.[105]

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[101] *Staff Report* at 267-268.

[102] *Staff Report* at 268, f.n. 854.

[103] This nomenclature and the standard derive from Rule 10(b)-5 of the Securities and Exchange Commission.

[104] 16 CFR § 436.1(a)(22).

[105] *Revised Rule*, § 436.7(a).

Also identical to the current Rule's paradigm is the revised Rule's "quarterly update" mandate. Under this requirement, a franchisor, following the close of each quarter of its fiscal year, must prepare revisions to be attached to its disclosure document to reflect any material change in the franchisor or relating to the franchise business of the franchisor, with each prospective franchisee receiving both the franchisor's core disclosure document and the quarterly revisions for the most recent period available at the time of disclosure.[106] While the revised Rule's language is somewhat ambiguous regarding what quarterly revision or revisions the prospective franchisee should receive (only the most recent quarterly revision or all quarterly revisions since the last annual update of the disclosure document), the Staff Report makes clear that "...prospective franchisees should receive the basic disclosure document and any quarterly updates that exist at the time the prospect is to receive disclosures,"[107] making clear that all quarterly updates since the last annual revision of the core disclosure document must be tendered.

Interestingly, the revised Franchise Rule contains no general continuing update requirement requiring franchisors to revise their disclosure documents to reflect material changes to the facts set forth therein. Instead, such a requirement pertains only to Item 19 financial performance representations (if any), requiring franchisors to "...notify the prospective franchisee of any material changes that the seller knows or should have known occurred in the information contained in any financial performance representation made in Item 19"[108]. Notably, the revised Rule does not specify how this updated Item 19 information is to be furnished to prospective franchisees - - by means of a revised core disclosure document or outside of that disclosure document (through separate writings or other communications).

The revised Rule's protocol of having franchisors delay incorporating material changes to the information contained in their disclosure documents until the Rule's required quarterly updates clashes with state franchise law requirements that such material changes require franchisors to cease offering and selling franchises until they amend their disclosure documents to reflect such changes.

California requires franchisors to "promptly" amend their disclosure documents upon the occurrence of any material change[109]. In Hawaii, that disclosure document amendment must be effected "...before further sales of the franchise."[110] In Illinois, "(w)ithin ninety days after the occurrence of any material change."[111] In Indiana, Maryland, New York, North Dakota and Rhode Island, a franchisor must amend its disclosure document "promptly" to disclose the material change.[112] In Minnesota, South Dakota and Wisconsin, a franchisor has thirty days within which to update its disclosure document to reflect any material changes to the facts set

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[106] *Revised Rule*, § 436.7(b).

[107] *Staff Report* at 224, f.n. 715.

[108] *Revised Rule*, § 436.7(d).

[109] California Franchise Investment Law, California Corporations Code, Div. 5, Parts 1-6, Section 31123.

[110] Hawaii Franchise Investment Law, Hawaii Rev. Stat., Title 26, Ch. 482E, Section 482E3.

[111] Illinois Franchise Disclosure Act, Illinois Compiled Statutes, Ch. 815, Section 200.604.

[112] Indiana Code, Title 23, Article 2, Ch. 2.5, Section 20; Maryland Franchise Registration and Disclosure Law, Ann. Code of Maryland, Business Regulation, Title 14, Section 02.02.08.06; New York General Business Law, Art. 33, Section 683(9)(a); North Dakota Franchise Investment Law, North Dakota Century Code Ann., Title 51, Ch. 51-19, Section 51-09-07; and, Rhode Island Franchise and Distributorship Investment Regulations Act, General Laws of Rhode Island, Title 19, Ch. 28.1, Section 19-28, 1-11.

forth therein.[113] Virginia requires amendment "upon the occurrence of a material change."[114] Lastly, Washington requires an update to a franchisor's disclosure document "...as soon as reasonably possible and in any case before the further sale of any franchise."[115]

Thus, the revised Rule's quarterly update requirement will prove of little consequence to franchisors operating in the above-referenced franchise regulating states. For if such franchisors do not immediately (or within the alternative minimum period specified in the above-referenced state franchise statutes) amend their disclosure documents to reflect material changes to the facts set forth therein, but instead wait to incorporate such changes in their FTC Rule quarterly updates, then such franchisors would be in violation of every state franchise registration and disclosure statute. Accordingly, most franchisors (at the least those operating in the franchise regulating states) will continue to immediately update their disclosure documents to reflect such material changes notwithstanding the revised Rule's more relaxed quarterly update protocol, a course of conduct which the Staff Report appears to anticipate and sanction.

XVI. EXEMPTIONS

The FTC Franchise Rule currently affords relatively few exemptions or exclusions from its coverage. Today, only "fractional franchises"; leased departments; franchise relationships requiring the payment of $500 or less before or within six months after commencement of operation of the franchisee's business; instances where no writing evidences any material term or aspect of the purported franchise relationship; employment relationships; cooperative associations; and, single trademark license agreements are exempted or excluded from FTC Rule coverage.

The revised Rule would maintain these exemptions and exclusions from Rule coverage - - but would add, in addition, a host of broad exemptions from disclosure. Note, in this regard, that while a number of state franchise registration/disclosure statutes afford exemptions from registration which parallel the following proposed Rule exemptions, only some of them exempt franchisors from engaging in disclosure. The Staff Report recognizes this, observing: "...(F)ranchisors exempted from disclosure under the revised Rule would nonetheless have to prepare and disseminate UFOC's in the 15 franchise registration states."

The first new exemption to be provided under the revised Rule pertains to petroleum marketers and resellers covered by the federal Petroleum Marketing Practices Act ("PMPA").[116] The Staff Report explains that, in 1980, the Commission granted a petition for an exemption from the Rule filed by several oil companies and oil jobbers, with the Commission concluding that the Rule should not apply to such PMPA-regulated franchises (the Commission noting in 1980 that the PMPA required its own scheme of pre-sale disclosure which duplicated that required under the Franchise Rule).[117]

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[113] Minnesota Statutes, Ch. 80C, Section 80C.07; South Dakota Franchises for Brand-Name Goods and Services Law, South Dakota Codified Laws, Title 37, Ch. 37-5A, Section 37-5A-40; and, Wisconsin Franchise Investment Law, Wisconsin Stats., Ch. 553, Section 553.31.

[114] Virginia Administrative Code, Title 21, Ch. 110, Section 5-110-40.

[115] Washington Franchise Investment Protection Act, Revised Code of Washington, Title 19, Ch. 19.100, Section 19.100.070.

[116] 15 U.S.C. § 2801.

[117] *Staff Report* at 229-230; 45 Fed. Reg. at 51,766.

In affording this PMPA exemption, the Commission stresses that it is not available to offers of non-petroleum franchises (such as convenience stores, fast food and ice cream shops) to be situated on the premises of petroleum (gasoline) retailers. "...(I)t would appear that an individual who operates a gasoline station is just as much in need of pre-sale disclosure for the purchase of a non-related franchise, such as an ice cream store, as any other member of the public."[118]

The revised Rule would also exempt from its coverage three categories of what the Staff Report refers to as "sophisticated investor" transactions.

The first pertains to transactions involving "large investments," that is, where the franchisee's estimated investment – excluding any financing received from the franchisor or an affiliate and further excluding real estate costs – totals at least $1 million, and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption.[119] The Staff Report confirms that no state has an identical exemption, although Illinois permits a franchisor to apply for an exemption from both registration and disclosure where the investment for a single franchise unit exceeds $1 million and Maryland exempts franchises that require an initial investment of $750,000 or more from registration (but not from disclosure).[120]

The reasoning underlying the "large investment" exemption proposed by the Staff Report is summarized therein: "The basis for the large investment exemption is not that 'sophisticated' investors do not need pre-sale disclosure, but that they will demand and obtain material information with which to make an investment decision regardless of the application of the Rule."[121]

As to what constitutes the required $1 million "investment" (excluding real estate costs and franchisor financing), the Staff Report indicates that this term will be defined in the FTC Franchise Rule Compliance Guide which will accompany the promulgation of the final Rule.[122]

For the time being, the Staff Report confirms that the threshold will be determined by the investment made at the time of sale; that the required investment threshold will apply both to single unit and multiple unit transactions ("(t)he total level of the prospective franchisee's investment, not the number of units purchased, is the primary factor underlying the proposed exemption"); and, that the value of assets which are the subject of franchise conversion or transfer transactions will count when computing the required threshold.[123] However, the Staff Report also makes clear that the exemption will apply only if at least one individual in a franchisee investor group qualifies as "sophisticated" by investing at the threshold level; a pooling of resources to reach that $1 million level will not alone, therefore, trigger the exemption.

Also not to be included when calculating whether the minimum exemption threshold has been reached is any money or financing furnished by the franchisor to the franchisee relating to the initial investment. "Otherwise, a franchisor could be tempted to increase the cost of the

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[118] *Staff Report* at 230-231.

[119] *Revised Rule*, § 436.8(5).

[120] *Staff Report* at 235 f.n. 756.

[121] *Staff Report* at 238.

[122] *Id.* at 242.

[123] *Id.* at 242-243.

initial investment to qualify for the large investment exemption, only to turn around and offer to finance the deal in itself, all without proper pre-sale disclosures,"[124] notes the Staff Report.

The second sophisticated investor exemption afforded by the revised Rule pertains to "large franchisees," defined as entities (including any parent or affiliates) which have been in business for at least five years and have a net worth of at least $5 million.[125] "Even if a large entity does not have prior experience specifically in franchising," asserts the Staff Report "it is reasonable to assume that it can nevertheless protect its own interests when negotiating a franchise purchase."[126]

The prospective franchisee entities entitling a franchisor to invoke this exemption include corporations, partnerships and any other business entities. As to individuals, the Staff Report concedes: "As a practical matter, the large franchisee exemption would also apply to individuals who purchase franchises. Any sophisticated investor who has been in business for at least five years and has generated an individual net worth of over $5 million would likely form a corporation or other entity in which to conduct business."[127]

The Staff Report also clarifies that commonly owned franchisee assets may be pooled when determining the availability of the large entity exemption so that, for example, affiliated franchisee entities each of whose assets are worth less than $5 million dollars but whose aggregate assets exceed that amount would enable a franchisor to invoke the exemption.

The final "sophisticated investor" exemption created by the proposed Rule pertains when one or more purchasers of at least a 50% ownership interest in the subject franchise within sixty days of the sale has been, for at least two years, an officer, director, general partner, or individual with management responsibility for the franchisor's franchise sales program or the administration of its network, or has been an owner of at least a 25% interest in the franchisor.[128] California, Washington and Rhode Island have similar exemptions. Asserts the Staff Report: "There does not appear to be any need for disclosure in such circumstances because we can reasonably assume that the prospective franchisee already is familiar with every aspect of the franchise system and the associated risks."[129]

The revised Rule provides that the FTC may adjust the above-referenced exemption thresholds every four years to account for inflation.[130]

A critical omission from the revised Rule's classification of "sophisticated investors" is the category one might have thought worthy – existing franchisees renewing or extending their franchise agreements or purchasing additional outlets. "While an argument could be raised that renewing franchisees already are familiar with the franchise system, that argument is undercut by the repeated submission of franchisee comments voicing concerns about renewal terms and conditions," states the Staff Report. "For similar reasons, we see little benefit in adopting a broad exemption for additional franchise sales to existing franchisees. A franchisee's

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[124] *Id.* at 244.

[125] *Revised Rule*, § 436.8(a)(6).

[126] *Staff Report* at 245.

[127] *Id.* at 246, f.n. 792.

[128] *Revised Rule*, § 436.8(a)(6).

[129] *Staff Report* at 249.

[130] *Revised Rule*, § 436.9(b).

experience within a franchise system alone is an insufficient basis to avoid pre-sale disclosure. In our experience, many franchise owners are not necessarily sophisticated about their franchisor, or are too busy operating their individual outlets to pay attention to developments within their franchise systems."[131]

XVII. ADDITIONAL PROHIBITIONS

The current prohibitions of the FTC Franchise Rule – making statements that contradict the franchisor's disclosures, failing to make promised refunds and failing to make available written substantiation for financial performance representations – are all retained in the proposed revised Rule.[132]

However, beyond the additional prohibitions already referenced in this report (failing to make disclosure documents available upon request to prospective franchisees earlier in the sales process than required by the Rule, failing to furnish disclosure upon request to prospective purchasers of existing franchised outlets, failing to redisclose upon request prospective franchisees who were previously disclosed but still in the franchise sales "pipeline"), the proposed revised Rule incorporates still others.

First, franchisors would be prohibited from utilizing "shills" in the franchise sales process by misrepresenting that any person actually purchased or operated one of the franchisor's franchises or could otherwise provide an independent and reliable report about the franchise, or the experiences of any current or former franchisees, when, in fact, such was not the case.[133]

Further, the revised Rule would forbid a franchisor from requiring a prospective franchisee to disclaim or waive reliance on any representation made in that franchisor's disclosure document (unless the waiver relates to a franchisee voluntarily waiving specific contract terms and conditions in the course of franchise sale negotiations).[134] Critically, it must be understood that the revised Rule does not purport to ban integration clauses or contractual waivers altogether; such provisions would only be prohibited from disclaiming disclosure document representations. So it is that franchisors, for example, could still utilize integration clauses and waivers to disclaim responsibility for unauthorized claims made by salespersons; statements made by former or existing franchisees; unattributed statements found in the trade press; third party representations; the franchisor's marketing materials; and, even materials in the franchisor's disclosure document which by definition are not applicable to the subject prospective franchisee (such as a financial performance representations regarding Florida units which are set forth in a disclosure document being furnished to a prospective Alaskan franchisee).[135]

Of critical import, the revised Rule's carveout from the aforementioned disclaimer/integration ban for franchise agreement changes negotiated by prospective franchisees does not expressly restrict those negotiations (and resulting waivers) to franchise agreement terms that are either as favorable or more favorable than those disclosed in the franchisor's disclosure document, leaving open the possibility (at odds with judicial decisions construing state franchise registration and disclosure statutes) that the forthcoming revised Rule

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[131] *Staff Report* at 233-234.

[132] *Revised Rule* at § 436.9(a)(d) and (j).

[133] *Revised Rule*, § 436.9(b).

[134] *Id.* at § 436.09(i).

[135] *Staff Report* at 258-260.

may permit franchise negotiations which result in greater franchisee obligations than those specified in the disclosure document. Indeed, the Staff Report observes: "...(T)he staff believes that franchise sellers and prospective franchisees should be free to negotiate the terms of the franchise agreement, as in all other commercial transactions, without fear of violating the Rule"... "The Commission has no interest in preventing the parties from seeking the best deal possible, as long as the prospective franchisee understands in advance of the sale how the terms and conditions differ from the standard ones set forth in the disclosure document and has the opportunity to review the actual franchise agreement prior to the sale."[136]

XVIII. PREEMPTION

As is the currently the case, the revised Rule provides that it does not intend to preempt the franchise laws of any state except to the extent of any inconsistency with the revised Rule. Also as today, the revised Rule would provide that a state law would not be deemed inconsistent with the Rule if it affords prospective franchisees equal or greater protection, such as by requiring registration of disclosure documents or more extensive disclosures.[137]

As observed earlier in this paper, however, the revised Rule would expand upon, and add to, the current UFOC Guidelines disclosure requirements mandated by the states. By doing so, as the Staff Report expressly acknowledges, the revised Rule "...would create a new disclosure floor with which all franchisors must comply."[138] While the Commission, in the Staff Report, invites the states to adopt the disclosure requirements of the revised Rule to further reduce inconsistencies between federal and state law, nevertheless, the above-referenced preemption language of the revised Franchise Rule would, in effect, mandate that the states both require and accept the expanded UFOC disclosures imposed by the revised FTC Franchise Rule.

However, many of the more striking features of the revised FTC Franchise Rule – first and foremost "pure" electronic disclosure – have no analogs in extant state franchise registration and disclosure statutes. While clearly such Rule provisions not governing disclosure document contents have no preemptive effect upon the franchise regulating states, nevertheless, it would be disheartening if the more visionary aspects of the Franchise Rule were not adopted by them. For otherwise, these salutary new Rule features would be confined for use only in the 35 states which have no franchise registration and disclosure statutes and are thus governed exclusively by the FTC Franchise Rule.

The ability of the franchise regulating states to incorporate the new "UFOC plus" disclosure mandates of the revised FTC Franchise Rule swiftly, if that is their desire, is complicated by the fact that, while many of those states require only regulatory amendments to accomplish this task (relatively easily done within a brief period of time), nine such states (Hawaii; Indiana; Maryland; Michigan; Minnesota; New York; North Dakota; and, Wisconsin) have franchise laws which themselves delineate what disclosures must be effected by franchisors (with some of these states amplifying such statutory requirements in regulations). Thus, at least some franchise regulating states – at the very least, those which have no amplifying disclosure regulations – must turn to their legislatures should they desire to adopt the revised Rule's disclosure requirements and other features.

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[136] *Staff Report* at 261-262.

[137] *Revised Rule*, § 436.10(c).

[138] *Staff Report* at 269.

Clearly, the harmonization of the new disclosure "floor" created by the proposed revised FTC Franchise Rule and the disclosure requirements of states featuring franchise registration and disclosure statutes, as well as the adoption by those states of some of the revised Rule's new and visionary elements, will prove a daunting and complicated task. However, it must be observed that the government officials responsible for federal and state franchise law administration have historically proven remarkably cooperative and diligent in their efforts to harmonize federal and state franchise regulation in a collegial and effective manner.

XIX. COMMENT PERIOD

The Federal Register Notice announcing the Staff Report, issued on September 2, 2004 provides that comments thereon will be accepted through November 12, 2004.

Comments filed in paper form should contain the reference "Franchise Rule Staff Report R511003" and be delivered or sent by overnight courier (due to security delays, not by U.S. mail) to: Federal Trade Commission, Office of the Secretary, Room H-159 (Annex W), 600 Pennsylvania Avenue, N.W., Washington, D.C. 20580.

Comments can be filed in electronic form by accessing the following web link: **https://secure.commentworks.com/ftc-franchisereport** and following the instructions found there. At that site you can also find a copy of the Federal Register Notice and the Staff Report.

XX. EFFECTIVE DATE OF REVISED FRANCHISE RULE

The Staff Report does not indicate, and we decline to speculate, when the Federal Trade Commission will adopt the revised Franchise Rule suggested in the Staff Report (as may be further modified following the above-referenced comment period). We do anticipate that the ultimate revised Rule will feature "phase in" period during which franchisors will have the opportunity to convert their disclosure documents to the new format required by the revised Rule.

XXI. CONCLUSION

The Staff Report and proposed revised FTC Franchise Rule are informed by remarkable intellect, imagination and responsiveness. Their objective – the modernization of federal franchise regulation in response to the massive changes in the economy, society, demographics, technology and franchising which have transpired over the past quarter century – has been equaled in ambition by the impressive effort undertaken by the Commission to ensure that it was taking the proper steps to achieve that goal.

ATTACHMENT A: COMPARISON OF UFOC AND PROPOSED FTC FRANCHISE RULE DISCLOSURE REQUIREMENTS

Disclosure Document	Revised FTC Staff Report Proposals: Rule Changes from UFOC Guidelines	Compliance Guides
Definitions		
Action	No change.	
Affiliate	"[A]n entity controlled by, controlling, or under common control with, the franchisor or a franchisee."	
Cooperative Association	(Not used in UFOC.)	Express exclusion eliminated, but remains a non-franchise relationship.
Confidentiality Clause	• New definition added: "Any contract, order, or settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor's system with any prospective franchisee. It does not include confidentiality clauses that protect franchisor's trademarks or other proprietary information." • [Term "gag clause" in original FTC proposal deleted.]	• Does not cover limited restrictions addressing specific contract terms (such as price, or concessions to a franchisee) if franchisees are free to discuss their overall experience in the franchise system.
Disclose, State, Describe, and List	"[P]resent all material facts accurately, clearly, concisely, and legibly in plain English."	Disclosures must be in at least 12 point upper and lower case type.

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
Financial Performance Representation	• "[A]ny oral, written, or visual representation to a prospective franchisee, including a representation in the general media that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. A chart, table, or mathematical calculation that shows possible results based on a combination of variables is a financial performance representation." • Expenses alone are not a financial performance representation. • [Reference to the internet in the original FTC proposal deleted.]	• Exclusions from general media claims currently in Final Interpretive Guides (communications to financial journals or the trade press in connection with bona-fide news stories, or directly to lenders in connection with arranging financing for franchisees) retained. • Exclusions to be expanded to include financial data filed with the SEC. No financial performance representation by posting on its web site investor information page a press release about financial status or data filed with the SEC, but will be a general media claim if posted on or linked from franchise offering information, or otherwise used as a marketing tool for the sale of franchises. • General media includes electronic online advertising such as unsolicited commercial email and banner or "pop-up" ads.
Fiscal Year	"[R]efers to the franchisor's fiscal year."	
Fractional Franchise	"[A] franchise relationship . . . [where] . . . [t]he franchisee or any of the franchisee's current directors or officers has more than two years of experience in the same type of business; and . . . the parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20 percent of the franchisee's total dollar volume in sales during the first year of operation."	Measure incremental sales resulting from the fractional franchise against total sales at all stores owned by the franchisee.

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
Franchise	• Any continuing commercial arrangement, whatever called, in which the terms specify, or the franchise seller represents, orally or in writing, that: (1) The franchisee has the right to operate a business, or sell goods or services, associated with the franchisor's trademark; (2) the franchisor provides significant assistance, or exerts or has authority to exert significant control, in the franchisee's method of operation; and (3) the franchisee makes or commits to make a required payment to the franchisor or its affiliate. (Exemption for required payments of less than $500 before 6 months after commencing business retained.) • [State "marketing plan" and "community of interest" definitions expressly rejected.]	• Business opportunities no longer covered by the proposed FTC Rule, and that exclusion emphasized by requirement of a "continuing" relationship. • To be significant, control must be over a substantial portion of the franchisee's overall business operation (but not necessarily to the franchisee's entire method of operation). Absent the presence of other controls or assistance, promotional assistance, location or account assistance, equipment maintenance and/or repair assistance, and the fulfillment of contractual obligations to provide inventory would not alone be deemed significant.
Franchise Seller	"[A] person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. It does not include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor."	A "broker" is a person who has a contract with the franchisor, receives compensation from the franchisor, and arranges franchise sales by assisting prospective franchisees in the sales process (*e.g.*, discussing specific business interests, pre-screening, recommending specific franchises, and assisting with applications). The definition is not limited to persons who negotiate contract terms, sign franchise agreements, or accept payments on behalf of a franchisor. The definition of broker would exclude existing franchisees who refer prospective franchisees to the franchisor because they have no contract with the franchisor to sell franchises. The definition would also exclude trade show promoters and the media who have no contract with the franchisor and do not receive compensation from the franchisor for selling franchises.

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
Franchisee	• "[A]ny person who is granted a franchise." • [The language in the original FTC proposed definition "any person to whom an interest in a franchise is sold" has been deleted.]	A franchisor's affiliates should not necessarily be considered franchisees.
Franchisor	"[A]ny person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors."	
Leased Departments	An arrangement where a retailer permits a seller to conduct business from the retailer's location where the seller purchases no goods or services directly or indirectly from the retailer, any person the retailer requires the seller to do business with, or any affiliate of the retailer if the retailer advises the seller to do business with the affiliate.	
Parent	"[A]n entity that controls the franchisor directly, or indirectly through one or more subsidiaries."	
Person	"[A]ny individual, group, association, limited or general partnership, corporation, or any other entity."	
Plain English	"[T]he organization of information and language usage understandable by a person unfamiliar with the franchise business. . . . short sentences; definite, concrete, everyday language; active voice; tabular presentation of information; no legal jargon or highly technical business terms; and no multiple negatives."	
Predecessor	• No change. • [Language in the original FTC proposal to also include anyone from whom the franchisor obtained a trademark or trade secrets license has been deleted.]	
Principal Business Address	The street address of the franchisor's U.S. home office. It cannot be a post office box or private mail drop.	
Prospective Franchisee	"[A]ny person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship."	• A representative can accept disclosures on behalf of a prospective franchisee. • Unilateral surfing of a franchisor's web site does not rise to the level of a "discussion" and alone does not turn the surfer into a prospective franchisee.

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
Required Payment	"[A]ll consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease."	Includes post-sale royalty payments.
Sale of a Franchise	"[A]n agreement whereby a person obtains a franchise from a franchise seller for value by purchase, license, or otherwise. It does not include extending or renewing an existing franchise agreement where there has been no interruption in the franchisee's operation of the business, unless the new agreement contains terms and conditions that differ materially from the original agreement. It also does not include the transfer of a franchise by an existing franchisee where the franchisor has had no significant involvement with the prospective transferee. A franchisor's approval or disapproval of a transfer alone is not deemed to be significant involvement."	• Upon renewal, entering into a new franchise agreement without any required payment, or extending an existing agreement for a fee, would not be a "sale of a franchise." • A modification of a franchise agreement, especially without new payment, would not be a "sale of a franchise."
Signature	"[A] person's affirmative step to authenticate his or her identity. It includes a person's handwritten signature, as well as a person's use of security codes, passwords, electronic signatures, and similar devices to authenticate his or her identity."	
Trademark	No change.	
Written	"[A]ny document or information in printed form or in any form capable of being preserved in tangible form and read. It includes: type-set, word processed, or handwritten document; information on computer disk or CD-ROM; information sent via email; or information posted on the Internet. It does not include mere oral statements."	

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
Cover Page		
Additional Information	• Adds references to FTC's web site and A Consumer's Guide to Buying a Franchise, the Franchisor's email and primary internet home page address, and the 14 (calendar) day delivery period. • Revised disclaimer that "no governmental agency has verified the information" in the disclosure document. • "Effective Date" changed to "Issuance Date."	
Electronic Disclosures	Franchisor may add optional contact information for prospect to obtain the disclosure document in a different format (*e.g.*, by email, electronic media, or paper).	
Item 5 & Item 7 Fees	Items 7 and 5 statement revised to state that Item 5 amounts are a subset of Item 7's total investment.	
Risk Factors	No required risk factor statements, but Franchisors may add risk factors (on the FTC cover page, a separate cover page or an addendum) to comply with non-preempted state law.	
Table of Contents		
	Conforms to 7 changed Item names: 1 – The Franchisor and any Parent, Predecessors, and Affiliates 5 – Initial Fees Paid to the Franchisor 7 – Estimated Initial Investment 11 – Franchisor's Assistance, Advertising, Computer Systems, and Training 19 – Financial Performance Representations 20 – Outlets and Franchisee Information 23 – Receipts	
Items		
1: The Franchisor and any Parent, Predecessors, and Affiliates		
Parent Information	Adds the name and principal business address (but not prior business history) of any parent entity that does not sell franchises or provide goods or services to franchisees. (Full affiliate disclosure required if parent entity sells franchises or provides goods or services to franchisees.)	

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Non-Rule Compliance Guides
Conflict of Interest	Adds disclosure of any competitor in which an officer of the franchisor owns an interest.	
Regulations		Explanation of types of laws to be disclosed (same as UFOC).
2: Business Experience		
Directors, Officers and Parents	• Disclosure of directors, trustees, general partners, and principal officers broadened to also include individuals who "occupy a similar status or perform similar functions." • Clarification that other executives and subfranchisors to be disclosed are those who have "management responsibility relating to the sale or operation of the franchises" • [Required disclosures may cover individuals who work for a parent, but original FTC proposal to disclose all parent officers, etc., deleted.]	
Brokers	Broker disclosures deleted (but may be included if required by state law).	
3: Litigation		
Individuals Listed in Item 2	No change (except for any additional individuals included in Item 2).	
Parents and Affiliates	• Added disclosures: • Parent litigation to be disclosed only if parent guarantees franchisor's performance. • Orders resulting from public agency actions against any affiliate that has offered franchises in any line of business within the last 10 years.	
Prior Civil Litigation		No disclosure required for settlements not materially adverse to franchisor, or actions dismissed without liability to franchisor (same as UFOC).
Confidential Settlements	No required disclosure of terms of confidential settlements entered into before franchisor commenced franchise sales, or before effective date of revised FTC Rule if franchisor previously used FTC disclosure format or is new to franchising.	

Disclosure Document	Revised FTC Staff Report Proposals	
	Key Changes from UFOC Guidelines	Compliance Guide
Franchisor-Initiated Litigation	Adds disclosure (in addition to categories already required in the UFOC) for any material civil action to which franchisor was a party during the past fiscal year (no quarterly updating required), involving the franchise relationship (contractual obligations directly relating to the operation of the franchised business, *e.g.*, royalty payments, training, and excluding actions involving third parties, *e.g.*, suppliers, indemnification for tort liability). For franchisor-initialed litigation, suits may be grouped under common summary headings (*e.g.*, royalty collection suits).	
4: Bankruptcy		
	No change. (As in UFOC, disclosure required for all affiliates, including parents, general partners, and actual and *de facto* officers, but not everyone listed in Item 2.)	
5: Initial Fees Paid to the Franchisor		
	No change.	• Franchisors may negotiate fees without violating the Rule. • Cost disclosures alone do not constitute a financial performance representation.
6: Other Fees		
	Adds disclosure of required payments made directly to third parties, stating the amount or that the amount is unknown and may vary depending upon factors such as the supplier selected.	Cost disclosures alone do not constitute a financial performance representation.
7: Estimated Initial Investment		
Initial Period	Initial period to be 3 months or "some other reasonable period for the industry" (allowing a period shorter than 3 months). [Original FTC proposal to disclose additional funds needed until "break even" deleted.]	• Franchisor has burden of showing reasonableness of any initial period other than 3 months. • Adopt NASAA Commentary that franchisee-owner's salary may be excluded from additional funds. • Cost disclosures alone do not constitute a financial performance representation.
8: Restrictions on Sources of Products and Services		
Conflict of Interest	Adds disclosure of any ownership interest in any supplier by an officer of the franchisor.	
9: Franchisee's Obligations		
	No change.	

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
10: Financing		
	No change.	Item 10 disclosure not required for payments due within 90 days on open account. Nothing in Item 10 restricts the negotiation of financing terms.
11: Franchisor's Assistance, Advertising, Computer Systems, and Training		
	• Computer system requirements need only be described generally (without separately identifying each hardware and software component by brand, etc.) • Disclosure of the table of contents of the manual (and the numbers of pages for each subject) can be omitted "if the franchisor offers the prospective franchisee the opportunity to view the manual before buying a franchise."	• A start-up franchisor can indicate that its computer requirements are not yet known. • [No indication that franchisors may list optional services as allowed under the NASAA Commentary.]
12: Territory		
Scope of the Disclosure	Broadens disclosure about competition through alternative channels of distribution, such as the internet, catalogs, and telemarketing, and about restrictions on franchisees conducting business outside of their territories or through alternative channels of distribution.	
Market Area	[The term "market area" in the original FTC proposal has been deleted.]	
Warning	Adds a mandatory warning if franchisor does not grant an exclusive territory: "You will not receive an exclusive territory. You may face competition from other franchisees or franchisor-owned outlets, or from other channels of distribution or competitive brands that we control."	
13: Trademarks		
	• No material change. • Changed warning for trademarks not federally registered: "Our trademark is unregistered. Therefore, our right to use the trademark may be challenged. If so, franchisees may have to change to an alternative trademark, which may increase your operating costs."	
14: Patents, Copyrights, and Proprietary Information		
	No change.	

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
15: Obligation to Participate in the Actual Operation of the Franchise Business		
	No change (except that disclosure of *all agreements* binding the franchisee's owners as required by the NASAA Commentary has been omitted).	
16: Restrictions on What the Franchisee May Sell		
	No change.	
17: Renewal, Termination, Transfer, and Dispute Resolution		
	Franchisors must explain their renewal policies in the summary of requirements for renewal (*e.g.*, franchisees must sign a contract with different terms than their original contract).	Examples of renewal policy statements to be included in Guides.
18: Public Figures		
	No change.	
19: Financial Performance Representations		
Preambles	• Mandatory statement added (in all cases) – franchisors may provide financial performance information if there is a reasonable basis for the information and it is included in the disclosure document, and information differing from Item 19 may be given only if the franchisor provides actual records of an existing outlet the prospect is considering buying, or if a franchisor supplements Item 19 with information about a particular location or under particular circumstances. • Second mandatory statement if the franchisor does not provide any financial performance information – the franchisor makes no representations about the future or past performance of company-owned or franchised outlets (except for actual records of an outlet being purchased); employees and representatives are not authorized to make any such representations, and a prospect who receives any such representation should report it to the franchisor's management, the FTC, and state agencies.	

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	New Compliance Guides
Geographic Relevance and Subgroups	• Financial performance information can be disclosed about a subgroup if there is a reasonable basis and the franchisor discloses the nature of the subgroup, the total number of outlets in the subgroup, the number of outlets in the subgroup that were measured, and any characteristics of the measured outlets that may differ materially from the outlet to be operated by the prospective franchisee. • Geographic relevance requirement deleted as a separate requirement from reasonableness.	Inconsistent contributing franchisee data may be used if franchisor can show reasonable basis.
GAAP	[The requirement in the original FTC proposal that historical financial performance data be prepared according to GAAP has been deleted.]	Earnings projections prepared in compliance with American Institute of Certified Public Accountants' standards for financial forecasts are presumed to be reasonable.

Disclosure Document	Revised FTC Staff Report Proposals	Compliance Guides
20: Outlets and Franchisee Information		
Double-Counting	5 separate tables (4 new, proposed by NASAA): 1 – ***System outlet summary***: The number of franchised and company-owned outlets at the beginning and end of last 3 fiscal years, and the total net changes. 2 – ***Transfers***: By state for the last 3 fiscal years. • "Transfer" defined as the acquisition of a controlling interest in a franchised outlet, during the term, by a person other than the franchisor or an affiliate (by definition, includes franchisee affiliates). 3 – ***Turnover of franchised outlets***: Franchised outlets at the start of the year, new outlets opened, terminations, non-renewals, reacquisitions by the franchisor, outlets that ceased to do business, and outlets at year end, by state for the last 3 fiscal years (multiple events during one year reported once by "last in time"). • "Termination" defined as the franchisor's termination of a franchise before the end of its term and without any consideration to the franchisee. • "Non-renewal" defined as when the franchise for an outlet is not renewed at the end of its term. • "Reacquisition" defined as the franchisor's reacquisition of a franchised outlet during the franchise term for consideration. 4 – ***Turnover of company-owned outlets***: Outlets at start of the year, new outlets, reacquired outlets, closed outlets, outlets sold to franchisees, and outlets at year end, by state for the last 3 fiscal years (multiple events during one year reported once by "last in time"). 5 – ***Projected Openings***: Unchanged from UFOC.	

Disclosure Document	Revised F.T.C. Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
Specific Outlet Turnover	New disclosure: Franchisor selling an existing outlet must disclose (by addendum) names and last known addresses and telephone numbers of owners for past 5 fiscal years, periods of their ownership, reasons for ownership changes, and periods of franchisor ownership.	
Confidentiality Clauses	New disclosure: Franchisors must disclose whether franchisees signed confidentiality clauses during the past 3 fiscal years, and if so, must add: "In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of franchise system]. While we encourage you to speak with current and former franchisees, be aware that not all such franchisees will be able to communicate with you." Franchisors may disclose the number and percentage of current and former franchisees who signed confidentiality clauses during each of past 3 fiscal years, and may disclose the circumstances.	No disclosure required for limited restrictions addressing specific contract terms (such as price, or concessions to a franchisee) that still permits franchisees to discuss their overall experience in the franchise system.
Franchisee Associations	Adds the name, address, telephone number, email address, and web address of each trademark-specific franchisee organization associated with the franchise system known to the franchisor, if the organization has been created, sponsored or endorsed by the franchisor, or is incorporated and asks to be included in the disclosure document during the next fiscal year. Disclosure on an annual basis only. (Requests must be made annually within 90 days after the franchisor's fiscal year end.) Franchisors may include the following disclaimer: "The following independent franchisee associations have asked to be included in this disclosure document. We do not endorse these organizations and their members may not represent all franchisees in the [name of franchisor] franchise system."	

Disclosure Document	Revised FTC Staff Report Proposals	
	Key Changes from UFOC Guidelines	Compliance Guides
21: Financial Statements		
Parent Financial Information	• Financial statements of parent or any other entity that commits to perform post-sale obligations for the franchisor, or guarantees the obligations of the franchisor, must be included. [Original FTC proposal requiring inclusion of parent financials in all cases deleted.] • A copy of any guarantee must be included. • All subfranchisors must furnish financial statements.	
GAAP	Financial statements must be prepared according to U.S. GAAP, or reconciled as permitted by the SEC with respect to foreign financials, or as revised by future government mandated accounting principles.	
Phase-In of Audited Financial Statements	A start-up franchisor may phase-in the use of audited financials over 3 years by providing: during the first partial or full fiscal year selling franchises – an unaudited opening balance sheet; during the second fiscal year selling franchises – an audited balance sheet as of the end of the prior fiscal year; and during the third and subsequent fiscal years – all required financials for the previous fiscal year plus any previously disclosed audited financials for the 2 fiscal years before that.	Audited financial statement phase-in available only to entities new to franchising that have not previously prepared audited financials. Phase-in not intended for spin-offs or affiliates of a franchisor where the franchisor has been engaged in franchising or has previously prepared audited financials.
22: Contracts		
	No change.	Item 22 refers only to those contracts that involve the franchise offering at the time of the sale, and not to future contracts that may only exist at some future date.
23: Receipts		
	No change.	

Disclosure Document	Revised FTC Staff Report Proposals	
	Rule Changes from UFOC Guidelines	Compliance Guides
Receipts		
	• Changes 10 business days to 14 (calendar) days. • Reference changed to "prospective franchisee's signature." • Timing language clarified: ". . . before you sign a binding agreement or make a payment with the franchisor or an affiliate . . .." • "Effective Date" changed to "Issuance Date." • Can include instructions for returning Receipt. • Broker information deleted. • [Requirement in original FTC proposal for 5 day waiting period between franchisor obtaining the Receipt and franchisee signing an agreement or paying money deleted from Receipt, although a 7 calendar day review period still applies if franchisor has initiated material changes in the contract.]	

The FTC received this comment in paper form, as well as multiple online comments submissions. The first online comment received was comment OL-100025, received 11/12/2004 at 12:51:31 PM. The first attachment was comment OL-100027, received 11/12/2004 at 1:16:42 PM. The second attachment was comment OL-100028, received 11/12/2004 at 1:20:03 PM. The third attachment was comment OL-100029, received 11/12/2004 at 1:23:35 PM. The forth attachment was comment OL-100031, received 11/12/2004 at 3:02:21 PM. The fifth attachment was comment OL-100034, received 11/12/2004 at 3:19:35 PM.