

## The Amended FTC Franchise Rule: Much Ado About Nothing?

Kevin J. Moran and Max J. Schott, II

\*Originally published in the Vol. 10, No. 3 issue of *The Franchise Lawyer*

At last. In somewhat anticlimatic fashion, the Federal Trade Commission (“FTC”) approved the amended FTC Franchise Rule (“Amended Rule”) on January 22, 2007, and released it and an accompanying Statement of Basis and Purpose to an eagerly-waiting franchise community and franchise bar. The Amended Rule revamps the old FTC Rule, which the FTC has not touched since its promulgation in 1978. Franchisors may choose to comply with the Amended Rule beginning July 1, 2007, during an initial phase-in period, and must comply with the Amended Rule starting July 1, 2008.



Kevin J. Moran



Max J. Schott, II

The Amended Rule represents the culmination of a 12-year amendment process conducted by the FTC and its staff. The process included an Advanced Notice of Proposed Rulemaking (1997), a Notice of Proposed Rulemaking (1999), and a Staff Report containing the Staff’s recommendations to the FTC regarding an amended version of the old FTC Rule (2004). Along the way, franchisors, franchisees and franchise attorneys have monitored the amendment process, debated the issues and provided comments to the FTC. So after all of the analysis, debate and build-up, is the FTC’s approval of the final version of the Amended Rule much ado about nothing? Yes and no.

Yes, in the sense that, despite a number of suggestions to the contrary, the Amended Rule did not expand the scope of old FTC Rule. The

Amended Rule still only mandates pre-sale disclosure and does not require any type of federal registration or approval. In addition, the Amended Rule does not regulate franchisor/franchisee relationships. More significantly, the Amended Rule simply adopts much of the existing UFOC Guidelines with some new twists. Accordingly, although adjusting Amended Rule will require franchisors to make some changes to their UFOCs (which become “Disclosure Documents” under the Amended Rule) and their disclosure practices, these changes will not be all that significant.

On the other hand, to argue that the Amended Rule is much ado about nothing, is to downplay the importance of the new twists, a number of which are desirable from a franchisor’s perspective. These new twists represent the efforts on the part of the FTC and its staff to improve the UFOC Guideline disclosure requirements and format. In this article, we briefly summarize what we see as the most significant and interesting of these new twists and discuss what franchisors can and should be doing now to gear up for the Amended Rule.

### ***Twist 1: First Personal Meeting Rule Eliminated*** (Farewell to the “Emergency” UFOC)

In what is sure to be welcome news to franchise development personnel everywhere, the Amended Rule eliminates the requirement to provide a Disclosure Document at the first personal meeting between the franchisor or its representative, and a prospective franchisee. Salespersons will no longer have to fret over whether a chance encounter with a prospect on a plane or at an expo has developed into a “first personal meeting.” Based on the FTC Staff’s Amended Rule FAQs on the FTC website (“Amended Rule FAQs”), however, it is clear that franchisors must continue to comply with the “first personal meeting” requirement until they

convert to the new disclosure format under the Amended Rule. In addition, in some registration states, the “first personal meeting” requirement will continue to apply unless the state changes its law.

***Twist 2: Waiting Periods Adjusted***

(What’s a “Business Day” Again? Who cares!)

In a minor departure from the previous 10-business-day rule, the Amended Rule requires disclosure at least 14 *calendar* days before the prospective franchisee signs a binding agreement or makes any payment. This means no more struggles over whether a given day falls on a weekend or some obscure holiday. A franchisor or its sales agent must, however, provide full disclosure earlier than 14 calendar days, if it is reasonably requested by the prospect.

The requirement to provide a completed franchise agreement 5 business days prior to execution becomes a 7-*calendar* day requirement. Importantly, however, the Amended Rule recognizes that “changes to an agreement that arise out of negotiations initiated by the prospective franchisee do not trigger [the] seven calendar-day period.” Again, unless certain registration states change their laws, business days will continue to be a part of their waiting periods.

***Twist 3: E-disclosure Confirmed***

(Franchisors Can Go Green and Save Green)

The Amended Rule explicitly allows document delivery in any manner that permits a prospect “to store, download, print, or otherwise maintain a copy for future reference.” Disclosure can now be completed by e-mail and through a franchisor’s website, provided that explicit instructions for viewing the Disclosure Document are given. Franchisors are permitted to include scroll bars, internal links and search features in their Disclosure Documents, as long as they are incorporated solely to enhance reader utility. Franchisors are expressly prohibited, however, from including in their Disclosure Documents any material not

specifically required under the Amended Rule (or by applicable state law) – including any multimedia tools such as audio, video, animation, pop-up screens, or links to extraneous information. Although some in the franchise bar have argued persuasively that electronic disclosure was *already* legal as a result of the federal E-SIGN legislation, this explicit clarification by the FTC is good news. The FTC Staff has also clarified in the Amended Rule FAQs that franchisors may begin electronic disclosure on July 1, 2007, even if they do not comply with the new disclosure format under the Amended Rule during the phase-in period.

***Twist 4: An End to Broker Disclosures***

(Maybe. Er—Maybe Not.)

Recognizing the substantial compliance costs associated with preparing broker disclosures, and the “scant benefit” provided by such disclosures, the Amended Rule omits any requirement to include broker information in Item 2. While this is good news for franchisors, some state franchise authorities have already suggested that broker disclosures are not likely to be eliminated from those states’ requirements.

***Twist 5: Greater Franchisor-Initiated Litigation Disclosures***

(Who’s Suing Whom.)

The Amended Rule requires a franchisor to disclose in Item 3 all “material” franchisor-initiated litigation involving the franchise relationship. The FTC intends to view materiality from the perspective of the hypothetical “reasonable prospective franchisee.” In other words, franchisors should be prepared to disclose most if not all lawsuits brought against franchisees. While this does impose a new requirement on franchisors, it applies only to the previous fiscal year (not a 10-year history) and franchisor-initiated litigation may be disclosed in summary fashion by category.

***Twist 6: Financial Performance Representations***

(An Earnings Claim by Any Other Name...)

Under the Amended Rule, “earnings claims” become “financial performance representations,” but remain voluntary and not mandatory. In a more noteworthy departure from the UFOC Guidelines, the FTC intentionally eliminated references to “expense” information from the definition of a financial performance representation. This change will allow franchisors to provide information on a franchisee’s expenses – without preparing a financial performance disclosure in their Disclosure Document. Also, unlike the UFOC Guidelines, the Amended Rule specifically permits financial performance disclosures pertaining only to certain “subgroups” and “subsets” of existing franchised or franchisor-owned units.

***Twist 7: Double-Counting Addressed***  
(More Tables, Less Confusion. Hopefully.)

To avoid the double-counting problem that often plagued the Item 20 tables under the UFOC Guidelines (for example, the need to classify an event affecting a single franchised unit as both “terminated” and “reacquired by franchisor”), the Amended Rule provides explicit definitions of change in ownership events. The Amended Rule also creates five separate reporting tables – current franchise system status, transfers, turnover rate among franchised units, turnover rate among company-owned units, and projected openings. In addition to the numbers in the turnover rate tables, franchisors are also required to disclose certain information about franchise outlets that were previously owned by a franchisee.

***Twist 8: Confidentiality Clauses***  
(Non-Disclosures Disclosed.)

The Amended Rule requires a franchisor to disclose whether, during the last three fiscal years, franchisees signed any confidentiality clause in a franchise agreement, settlement agreement, or any other contract with the franchisor. If so, a franchisor must include in Item 20 of its Disclosure Document the specific language required under the Amended Rule. Franchisors may also, if they choose, disclose the

number and percentage of current and former franchisees who signed confidentiality agreements and the circumstances under which they were signed.

***Twist 9: Franchisee Association Disclosures***  
(Ask and Ye Shall Receive...)

The Amended Rule requires franchisors to list basic identifying information regarding trademark-specific franchisee associations that: (1) have been created, sponsored, or endorsed by the franchisor; or (2) are incorporated or otherwise organized under state law and ask to be included in the Disclosure Document during the next fiscal year. These organizations must renew their request for inclusion on an annual basis by submitting a request no later than 60 days after the close of the franchisor’s fiscal year.

***Twist 10: Financial Statements***  
(When Your Parents Cover for You)

In a departure from earlier staff recommendations, which would have required disclosure of the financial statements of a franchisor’s parent in all situations, the Amended Rule will require this disclosure only under two situations: (1) if the parent commits to perform *required* post-sale obligations on behalf of the franchisor; or (2) if the parent guarantees the obligations of the franchisor. As clarified in the Amended Rule FAQs, the mere sale of goods or services to franchisees by a parent will not trigger this disclosure requirement, unless the franchisor is contractually obligated to supply such goods or services to franchisees. The Amended Rule also requires franchisors to include a copy of any parent guarantee in the Disclosure Document.

***Twist 11: New Exemptions***  
(Some People Can Just Take Care of Themselves)

The Amended Rule adds a new exemption for relationships covered by the Petroleum Marketing Practices Act, and three new “sophisticated investor exemptions” – one for “large investments,” one for “large franchisees,” and one for certain previous franchisor “owners,

officers and managers.” While these new exemptions may be useful in certain situations, franchisors should not lose sight of the benefits of full disclosure, including the prevention of claims of fraud and misrepresentation and antitrust violations.

### **Conclusion – Preparation for Implementing the Amended Rule**

(Now What?)

As we approach the year-long phase-in period beginning July 1, 2007, perhaps the biggest question still looming is how the registration states will respond. As with the old FTC Rule, the Amended Rule sets the floor for what must be disclosed by franchisors, but specifically declines to preempt the field. This means states will still have the ability to impose greater disclosure requirements than those at the federal level. For example, in addition to maintaining broker disclosures, some state authorities have also indicated that they are unwilling to follow the FTC’s decision to eliminate the cover page risk factors. NASAA is working with the registration states to come up with plan that will hopefully “harmonize” the Amended Rule with state franchise disclosure laws – which after all was one of the FTC’s primary goals in amending the old FTC Rule.

While the state issues play themselves out, franchisors should determine a strategy and timeline for compliance with the Amended Rule. The FTC is expected to release a compliance guide by July. In the meantime, it is not too early for franchisors to begin collecting and reformatting information from this and past years (like the tables in Item 20) for eventual inclusion in their new Disclosure Documents. Franchisors should also develop an electronic disclosure policy and process, especially if they plan to take advantage of this option on July 1. Franchisors should also keep in mind that any franchisor-initiated litigation they bring in 2007 may potentially end up in their Disclosure Documents at some point in 2008.

While there will inevitably be a somewhat trying transition period as states and franchisors adjust

to the Amended Rule, the FTC’s new twists will eventually bring about the positive goals they worked so hard over the past 12 years to accomplish.

---

*Max Schott is a principal and Kevin Moran is an associate in Gray Plant Mooty’s Franchise & Distribution practice group.*