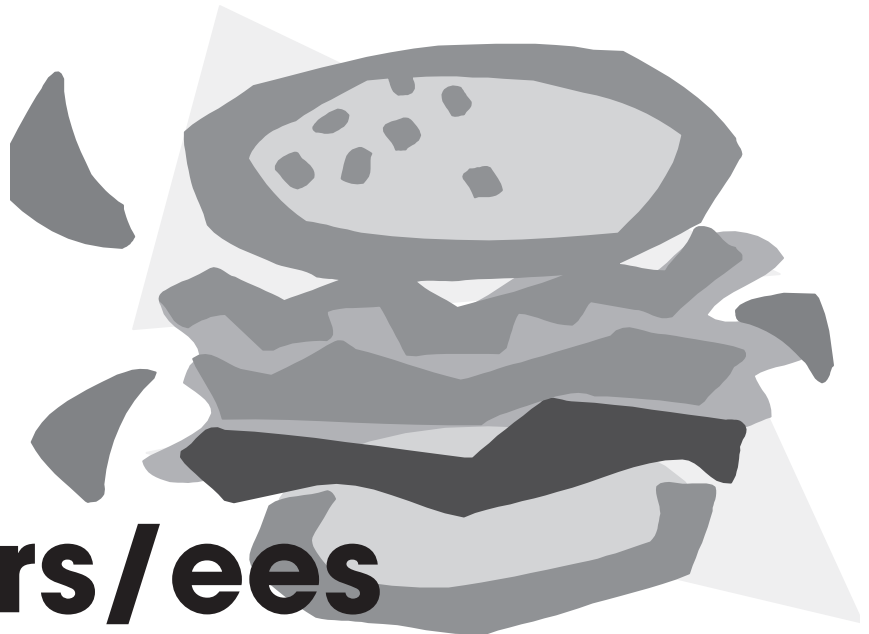


New FTC franchise disclosure docs

Effect on franchisors/ees



It's been almost 30 years since the FTC issued new rules on franchisor disclosures. The revisions simplify the process while requiring more actionable information.

By Terrence M. Dunn

When the Federal Trade Commission (FTC) first issued its Rule on Franchising in 1978, it did so in the spirit of helping potential buyers become better informed before purchasing a franchise. A major component of this rule was requiring franchisors issue an annual Uniform Franchisor Offering Circular (UFOC), which contains a wide range of disclosures.

With the release of its Amended Franchise Disclosure Rule in January 2007, the FTC has gone several steps further to make franchisor compliance simpler and more convenient, and to protect potential franchisees. The new rule promises

to dramatically alter how franchisors disclose information regarding their operations in the now required Franchisor Disclosure Document (FDD), and changes the landscape of how franchisors sell their concept to potential buyers.

Although the new rules went into effect on a voluntary basis on July 1, 2007, franchisors have until July 1, 2008 to comply. Many franchisors still have not done so. Recognizing the effort necessary to implement the rules, we've encouraged our clients to develop their disclosure documents in the new format as soon as possible. We're spending considerable time educating and advising clients on both legalities and practical effects, especially regarding (i) their operating procedures, (ii) how they sell future franchises to potential franchisees, (iii) franchisee relations, (iv) red flags that may now arise, and (v) how best to achieve full regulatory compliance.

Franchisor benefit — simplification of disclosure requirements

The Amended Franchise Disclosure Rule provides franchisors with significant substantive and logistical relief in preparing and disseminating their disclosure document. Chief among these benefits is allowing franchisors to provide representations of financial performance (earnings claims) outside of the FDD without making these same disclosures in the actual FDD. The rule also permits franchisors to provide franchisees with "cost only" information as well as information relating to the performance of a specific subset of franchisees. Ultimately, the rule will afford franchisors greater flexibility in how they provide financial information to the general media, on websites, in speeches and SEC filings, and greater control over what kind of financial information is made available to franchisees, if any.

Timing of disclosures

A second major revision benefiting franchisors is overhaul of the disclosure timing requirements. No longer must franchisors deliver disclosure documents to a potential buyer during the “first personal meeting” — always a confusing term. Also eliminated is the five-day rule for delivering execution-ready agreements. In their stead, the rule simply requires that a franchisor deliver its disclosure document to a potential buyer 14 days before that buyer signs the franchise agreement or gives the franchisor consideration for the franchise. Additionally, in keeping with advancements in technology, franchisors will now be permitted to make electronic disclosures.

Another significant amendment requires the franchisor to simply provide the name and address of its parent company unless the parent company furnishes products or services to franchisees, in which case more extensive disclosure is required — detailed information relating to its parent company’s business, litigation and bankruptcy history.

Another change eliminates the requirement that franchisors disclose “risk factors” on the FDD cover page. The 13 states requiring FDD registration may still require inclusion of “risk factors,” but where not state-mandated, registration may be simpler.

For those franchise systems electing to use brokers to locate potential franchisees, the new FTC rule lessens a franchisor burden by eliminating the requirement they disclose their brokers.

Point of sale and computer equipment

Franchisors frequently require franchisees employ high-end point-of-sale equipment and other complex computer systems. The amendment reduces the disclosure requirements relating to these systems; franchisors need only provide a general summary of the required technology systems rather than detailed descriptions of brands, types and functions of any required point of sale or other computer system.

The amendment also contains numerous changes in the manner in which franchisors implement their disclosure obligations. Franchisors will have additional time after the end of their fiscal year to prepare their annual update (120 days versus 90 days); foreign franchisors will be allowed to provide financial statements in accordance with Securities and Exchange Commission requirements (versus traditional GAAP accounting principles).

Franchisee benefits: Additional disclosure requirements

In general, the Amended Franchise Disclosure Rule requires and encourages a franchisor be more forthcoming, thereby furnishing a potential buyer with more information to be used in determining whether to purchase that franchise.

Among the new disclosures is the “expansion of business experience” disclosure, including a requirement the franchisor disclose the names and employment history of all franchisor officers and directors as well as anyone who has management responsibility relating to the franchise, regardless of formal title and regardless of whether that individual is an employee of the franchisor’s parent or affiliate. Further, the franchisor must cite the bankruptcy history of any individual with such management responsibility. Hence, franchisees will be provided with a great deal of information regarding those directly involved in the franchisor’s operational activities.

Territories and trademarks

Also critical to the new rule are amendments affecting disclosures relating to territory protection and patent/trademark registrations. With the former, franchisors not offering franchise protection — exclusive territories — must now state this as fact in the disclosure document. As to the latter, if a franchisor does not have a federally registered trademark, that franchisor must specifically inform franchisees that the franchisor’s trademark will not have many legal benefits and rights associated with it, and advise the franchisee of the possibility of needing a new trademark and/or increased expenses should the franchisor’s trademark be challenged. Furthermore, franchisors must now also disclose all patents for which it has applied, in addition to previously required information on patents already granted by the U.S. Patent and Trademark Office.

Transparency

The new rule imposes greater transparency in the franchise system by requiring a franchisor disclose:

1. its rights to use other channels of distribution within the franchisee’s territory;
2. any confidentiality clauses restricting franchisees from discussing their experience within the franchise system; and
3. the existence of any franchisor initiated material litigation against franchisees during the prior fiscal year.

The new rule also completely overhauls Item 20, eliminating the “double counting”

of franchise transactions often giving the appearance of a turbulent franchise system.

A franchisor must now clearly define the term “renewal” within the franchise system. Each franchise system is unique and “renewal” could mean anything from operating the franchise under the terms of the original franchise agreement to continuing the franchise relationship under the terms of an entirely new and different franchise agreement.

Other changes require franchisors:

1. write their disclosure document in “plain English”;
2. provide additional disclosures relating to any suppliers in which the franchisor holds an ownership stake;
3. document all trademark or franchisee associations; and
4. provide resource information on the cover page to assist potential franchisees make an educated decision regarding a possible franchise purchase.

Overall, the new rules are designed to provide more decision-making information to the franchise buyer, while making the disclosure process considerably easier for the franchisor.

Nevertheless, the new rules are complex and should be applied carefully: Franchisors and potential franchisees, as well as their legal counsel, are urged to educate themselves on the nuances and opportunities present in the new Amended Franchise Disclosure Rule. ☉



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