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Setting precedent.

# **Adapting to the Amended FTC Rule**

by:

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# Overview of Changes

1. FDD, interpreted by FTC, replaces UFOC, interpreted by states.
2. Electronic delivery is permitted.
3. 1<sup>st</sup> personal meeting/10 business day requirement is replaced with 14 calendar day requirement.
4. 5 business day cooling off period for contract modifications is eliminated.
  - only if franchisor unilaterally changes disclosed agreements is a 7 calendar day cooling off period imposed.

# Overview of Changes

5. Foreign franchise sales are exempt
6. New exemptions exist based on:
  - investment amount.
  - franchisee business experience and net worth.
  - franchisor insiders investment in franchisees.
7. Franchise broker disclosures are eliminated.

# Overview of Changes Continued

8. New Disclosures Are Required:
  - Parents
  - Franchisor initiated litigation
  - Suppliers in which franchisor officers own an interest
  - Franchisee associations
  - Use of nondisclosure agreements
  - Prior owners of outlets resold by franchisor.
9. “Earnings Claims” replaced with Financial “Performance Representations” (“FPRs”) and rules are relaxed.

# Overview of Changes

10. Annual update is required within 120 days after FYE, rather than 90 days.
11. Item 20 Charts are more user friendly.

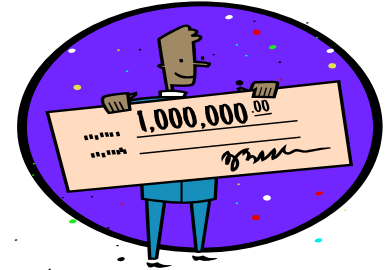
# What Has Not Changed

1. Complexity & length of disclosure.
2. Audit requirements (for US franchisors).
3. States right to register franchises and to require more disclosure.
4. FPRs (Earnings Claims) are optional.
5. Former interpretations of FTC Rule and UFOC will be carried forward.
6. Plain English requirement.

# **New Exemptions and Exclusions**

1. Sales of outlets to be located outside of the US.
2. Business opportunities.
3. \$1 million investment.
4. 5 year experience, \$5 million net worth.
5. Franchisor related party owns ½ franchisee.

# Exemptions



## \$ 1 Million initial investment

- \$ 1 Million includes investment in multiple franchises under: Area Development and Master Franchise Agreements.
- \$1 Million does not include:
  - Amounts financed by the franchisor and its affiliates.
  - Investments in unimproved real property (“raw land”)

# Exemptions Continued

**5+5**

\$5 Million net worth and 5 years business experience of franchisee, its parent or affiliates.

## Exemptions

### Franchise Officers, Managers and Owners

- a. If Franchisor or one or more of its officers, directors, general partners, owners, or managers...
- b. Owns at least 50% of prospective franchisee, the sale is exempt.
  - officers, or managers, etc. must have been associated with the franchisor for at least 2 years.
  - have continued the association with the franchisor until 60 days before the franchise sale.
  - owners must own at least 25% interest in franchisor and have had such interest for at least 2 years up to 60 days before sale.

# **Exemptions & Exclusions Retained**

1. Minimal Payments
2. Fractional Franchises
3. Leased Departments
4. Franchises governed by PMPA
5. Oral franchises

# Prohibitions

## New Prohibitions

1. Use of skills for bogus endorsements.
2. Failure to provide disclosures earlier than 14 days before signing or paying, if a prospect makes a reasonable request.
3. Failure to provide a prospect with any quarterly updates prepared by the franchisor after the original FDD was provided, upon a prospect's reasonable request.

# Prohibitions

4. Requiring a prospect to waive reliance on any information in a FDD.
  - Not intended to prevent a prospect from voluntarily waiving disclosed contract terms.

# Prohibitions Retained

1. Making statements which are inconsistent with what is disclosed.
2. Making unauthorized Financial Performance Representations (earnings claims).
3. Failure to deliver promised refunds.
4. Failure to meet the new presale disclosure timing requirements.

# Delivery Requirements

1. 14 calendar days before signing or paying.
2. 7 calendar days notice of franchisors unilateral changes to the disclosed franchise agreement terms.
  - Counting
    - 14 days begins day after delivering of FDD;
    - Signing or paying allowed on the 15<sup>th</sup> day after delivery.

# Delivery Requirements

3. Electronic disclosure is permitted in any form which is capable of being preserved.
  - no external links.
  - only required or expressly permitted content may be used.
  - scroll bars and other navigational features are ok.
  - directions for accessing e-disclosures must be provided at time of delivery.

# Delivery Requirements

4. Delivery receipts must be kept for 3 years after FYE.
5. Sample copies of each materially different FDD must be kept for 3 years after FYE.

# **Highlights of Changes to UFOC Disclosures**

# New Disclosure Requirements

- New FTC Cover Page
  - FRANCHISE DISCLOSURE DOCUMENT, NOT UFOC.
  - Include e-mail address, primary Internet URL.
  - Disclose total Item 7 investment, including Item 5 totals.
  - Add FTC warnings.
- Optional Disclosures
  - May alert prospects that disclosure is available in other formats.
  - May include disclosures required *to comply with state laws*.

# New Disclosure Requirements

- New Item Titles
  - Item 1 – The Franchisor and any Parents, Predecessors and Affiliates
  - Item 5 – Initial Fees
  - Item 7 – Estimated Initial Investment
  - Item 11 – Franchisor’s Assistance, Advertising, Computer Systems, and Training
  - Item 19 – Financial Performance Representations
  - Item 20 – Outlets and Franchisee Information

# New Disclosure Requirements

- Item 1
  - Disclose names and business addresses of any “parents”
    - A “parent” is an entity that controls another entity directly or indirectly through one or more subsidiaries.
  - Principal business address may not be a post office box.

# New Disclosure Requirements

- Item 2
  - Identify individuals who exercise management responsibility over the sale or operation of the franchises offered.
    - Could include parent company personnel.
  - Franchise broker disclosure eliminated.

# New Disclosure Requirements

- Item 3
  - Disclose parent or affiliate litigation, if the parent or affiliate guarantees franchisor's performance.
  - Expands litigation disclosures to include franchisor affiliates that have offered franchises in *any line of business* within the last 10 years.

# New Disclosure Requirements

- Item 3
  - Disclose material franchisor initiated litigation
    - Involving the franchise relationship.
    - Commenced during the last fiscal year.
      - Includes contract claims.
      - Does not include third party actions of suppliers or others, or indemnification claims for tort liability.
  - Summary disclosure permitted.
    - No requirement to continue disclosing franchisor initiated litigation in subsequent years.
    - Franchisor initiated litigation which is subject to franchisee counterclaims is governed by old UFOC standards.

# New Disclosure Requirements

## – Item 4

- Disclose bankruptcy proceedings for any parent, predecessor and those with management responsibility who are disclosed in Item 2.

# New Disclosure Requirements

- Item 5
  - “Initial fees” includes commitments to pay the franchisor or an affiliate at a later date.
- Item 6
  - Disclose whether ongoing fees are uniformly imposed.

# New Disclosure Requirements

- Item 8

Identify all suppliers in which an officer of the franchisor owns an interest.

# New Disclosure Requirements

- Item 11
  - Except as listed below, [the franchisor] is not required to provide you with any assistance [“must be in bold type”].
  - Disclosure is required of “franchisor’s principal assistance and related obligations of both the franchisor and the franchisee....”

# New Disclosure Requirements

- Item 11
  - Simplifies disclosures relating to electronic cash registers and computer systems include:
    - The cost of purchasing or leasing.
    - Obligations of the franchisor, an affiliate or third party to provide ongoing maintenance, repairs, upgrades, or updates.
    - The annual cost of optional or required maintenance, updating, upgrading or support contracts.
    - Detailed descriptions of hardware and software are not required.

# New Disclosure Requirements

- Item 11
  - Training
    - Specific disclosures focus on initial training.
    - New table contains headings: subject, classroom hours, on-the-job hours and location.
    - Instructional materials and instructors' experiences are to be disclosed in a narrative following the table.
    - If training is not mandatory, give the percentage of new franchisees that enrolled in the program during the preceding 12 months.
    - If successful completion of training is required, state how long after signing the agreement or before opening, the training must be completed.
    - State whether additional training or refresher courses are required.
      - No other ongoing training disclosures are specified.

# New Disclosure Requirements

- Item 12
  - If no “exclusive territory” is awarded, state: “You will not received an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.”
  - Adds detailed disclosures about franchisor’s right to use other distribution channels.
  - Adds disclosures about restrictions against solicitation outside “exclusive territory.”
  - Disclose “any minimum territory granted to the franchisee.”
    - “Territory” is undefined.

# New Disclosure Requirements

- Item 13
  - If a “principal trademark” is not registered with the USPTO, state: “We do not have a federal registration for our principal trademark. Therefore, our trademark does not have many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses.”

# New Disclosure Requirements

- Item 17
  - Define what “renewal” means under your franchise agreement.

# New Disclosure Requirements

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

# New Disclosure Requirements

- If no FPR is included in FDD, state:
  - We do 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, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

# New Disclosure Requirements

- Item 19 (continued) –
- Geographic relevance standard eliminated.
- FPRs are permitted for subgroups of units.
- Excludes from FPR definition, claims made on websites which are targeted to investors, rather than to prospective franchisees.

# New Disclosure Requirements

- Item 20
  - New table format.

# Table 1: System Status

<b>Column 1</b>	<b>Column 2</b>	<b>Column 3</b>	<b>Column 4</b>	<b>Column 5</b>
<b>Outlet Type</b>	<b>Year</b>	<b>Outlets at the Start of the Year</b>	<b>Outlets at the End of the Year</b>	<b>Net Change</b>
<b>Franchised</b>	<b>2004</b>			
	<b>2005</b>			
	<b>2006</b>			
<b>Company-Owned</b>	<b>2004</b>			
	<b>2005</b>			
	<b>2006</b>			
<b>Total Outlets</b>	<b>2004</b>			
	<b>2005</b>			
	<b>2006</b>			

# Table 2: Franchise Transfers

<b>Column 1  State</b>	<b>Column 2  Year</b>	<b>Column 3  Number of Transfers</b>
	<b>2004</b>	
	<b>2005</b>	
	<b>2006</b>	
	<b>2004</b>	
	<b>2005</b>	
	<b>2006</b>	
<b>TOTAL</b>	<b>2004</b>	
	<b>2005</b>	
	<b>2006</b>	

# Table 3: Franchise Turnover Rate

Col. 1 State	Col. 2 Year	Col. 3 Outlets at Start of Year	Col. 4 Outlets Opened	Col. 5 Terminations	Col. 6 Non-Renewals	Col. 7 Reacquired by Franchisor	Col. 8 Ceased Operations -Other Reasons	Col. 9 Outlets at End of the Year
	2004							
	2005							
	2006							
	2004							
	2005							
	2006							
<b>TOTAL</b>	2004							
	2005							
	2006							

# Table 4: Company-owned Turnover Rate

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
State	Year	Outlets at Start of Year	Outlets Opened	Outlets Reaquired From Franchisee	Outlets Closed	Outlets Sold to Franchisee	Outlets at End of the Year
	2004						
	2005						
	2006						
	2004						
	2005						
	2006						
TOTAL	2004						
	2005						
	2006						

# Table 5: Projected Openings

Column 1	Column 2	Column 3	Column 4
State	Franchise Agreements Signed, But Outlets Not Opened	Projected New Franchised Outlets In The Next Fiscal Year	Projected New Company- Owned Outlets In The Next Fiscal Year
<b>Totals</b>			

# New Disclosure Requirements

- Item 20 (continued)
  - Notify prospective franchisees that their contact information will be disclosed in future FDDs.
  - Disclose contact info regarding each franchised outlet owner over last 5 years for each outlet the franchisor offers for sale, plus reasons for the acquisition and resale, and the time period when franchisor controlled the outlet.

# New Disclosure Requirements

- Item 20 (continued)

If franchisees have signed “confidentiality clauses,” state:

- “In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of franchise system]. You may wish to speak with current and former franchisees, but be aware that not all such franchisees will be able to communicate with you.”
- Option to disclose number and % of current/former franchisees who have signed confidentiality agreements during last 3 fiscal years and the reasons therefore.

# New Disclosure Requirements

- Item 20 (continued)
  - Disclose “trademark specific” (not IFA, AAFFD) franchisee associations contact info if organization:
    - Created, sponsored or endorsed by the franchisor.
      - Describe relationship between association and franchisor.
    - Association is incorporated or “otherwise organized” under state law and requests inclusion in the FDD no later than 60 days after franchisor’s FYE.

# New Disclosure Requirements

- Item 21
  - Audited statements under U.S. GAAP or other country GAAP as permitted by SEC.
  - Parent/subfranchisor statements required if parent/subfranchisor (a) guarantees or (b) formally “commits to perform post-sale obligations for franchisor”. Guarantees must be included in the disclosure document.

# Transition Issues

- E-disclosure is permitted.
- Until July 1, 2008, use old format everywhere, or new format everywhere.
- Guidelines are expected soon.
- Information required by new format must be compiled early.
- File early.
- FTC posts answers to FAQs at [www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml](http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml).

# State-Federal Issues

1. More protective state law requirements remain in place
  - Registration
  - Additional disclosures
  - Relationship laws
2. No state has adopted FTC's new disclosure exemptions.
3. Franchisor exemptions under state business opportunity laws depend upon disclosure in IA, NE & OK.
  - Business opportunity disclosure, rather than FDD may be used.

# State-Federal Issues

4. NASAA has adopted FDD as “successor to UFOC Guidelines”
  - NASAA has adopted a State Cover Page to follow the FTC prescribed page.
    - Warns that renewal only may be offered on terms which are different from what is in FDD, and that franchisee may be required to meet conditions to renew.
  - Retains risk factors regarding:
    - Foreign venue
    - Use of mediation or arbitration
    - Foreign law
  - Warns prospects to investigate brokers who are paid fees to make referrals to franchisors
  - New receipt.

# State-Federal Issues

5. Indicate which format is used on all pre-July 1, 2008 filings.
6. Few states will accept filings 120 days of the fiscal year end unless that date is the anniversary of registration effectiveness.
  - Exceptions: MN, NY, SD

# **New Information Which Must be Collected**

1. Contact information regarding parents
2. Formal agreements between parents and franchisor to:
  - a. Provide services to franchises
  - b. Guaranty franchisor's obligations
3. Copies of all complaints or other documents filed during franchisor's last FYE against current or former franchisees.
4. Identity of all franchisee supplies in which franchisor officers own an interest, and the names of each such officer.

# New Information Which Must be Collected

5. Copies of all confidentiality agreements with current or former franchisees during last 3 fiscal years **IF** franchisor wishes to disclose number and % of franchisees who have signed them.
6. Contact information and relationship information about all Franchise Advisory Councils and independent franchise associations which request inclusion in FDD.
7. Contact information regarding previous owners of all former franchised outlets during last 5 fiscal years which are to be sold by the franchisor, and reasons for franchisor's acquisition(s) and periods of franchisor, and each franchisees' ownership of the outlet.

**Thank you**

Haynes and Boone, LLP