



# Franchise Law Alert

## Recent developments in franchise law

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### Federal Trade Commission adopts new Franchise Rule

The Federal Trade Commission (FTC) approved an amended Franchise Rule on January 22, 2007. The amendments change what franchisors are required to disclose in their Uniform Franchise Offering Circulars (UFOCs) and the timing requirements for making disclosure. A final, official version of the amended Franchise Rule is expected to be published in the *Federal Register* shortly. The amended Franchise Rule goes into effect on a voluntary basis on July 1, 2007. On July 1, 2008, the amended Franchise Rule will become mandatory. In this *Alert*, we summarize the key changes that have been adopted in the amended Franchise Rule.

In its August 25, 2004, Staff Report, the FTC Staff recommended a variety of changes to the Franchise Rule, including abandoning the FTC format and adopting the UFOC disclosure format with modifications. The final, amended Franchise Rule is similar, but not identical to, the proposed Franchise Rule discussed in the 2004 Staff Report.

#### Key changes to the Franchise Rule

##### What transactions are covered?

###### *Exemptions*

- The Franchise Rule will not apply to (1) franchisees making major initial investments of more than \$1 million (but excluding real estate and amounts that are franchisor-financed) and that sign an acknowledgement; (2) large franchisees (at least five years in business, with a net worth of at least \$5 million); or (3) “insider” franchise purchases involving owners or officers of the franchise system, or managers with at least two years’ management experience in the franchise system.

###### *Inapplicable to out-bound international franchise sales*

- The Franchise Rule will apply only to franchise locations in the United States or its territories.

###### *Business opportunities excluded*

- “Business opportunities” (for example, advertised schemes to make money providing vending machines or display racks) will no longer be covered by the Franchise Rule. Instead, they will be regulated by a separate rule, which the FTC also approved on January 22. We will address these changes in a separate Franchise Law Alert.

## **Who makes and receives disclosure/When must disclosures be made?**

### *No “first personal meeting” requirement*

- In a significant change, the amended Franchise Rule eliminates the “first personal meeting” requirement. Now, franchisors must deliver the UFOC at least 14 calendar days before the franchisee signs a contract with the franchisor or pays any money to the franchisor. Previously, the requirement was delivery to the prospective franchisee at the earlier of the “first personal meeting” or 10 business days before receipt of money or execution of any franchise-related agreements.

### *Separate furnishing of completed franchise agreement no longer required*

- Significantly, the final form of franchise agreement no longer has to be provided to a prospective franchisee five business days before signing the agreement. However, a final copy of the franchise agreement must be disclosed to the prospective franchisee if the franchisor unilaterally makes material changes to the form agreement that is included in the disclosure document. The time for such disclosure is seven calendar days before execution of the agreement, instead of five business days. Negotiated changes initiated by the franchisee do not trigger the seven-calendar-day period.
- The amended Franchise Rule specifies what constitutes “delivery” to address uncertainties as to timing.

## **Electronic delivery/Execution**

- The amended Franchise Rule greatly simplifies the process for franchisors to provide electronic disclosure.

### *Delivery*

- Before delivery, the franchisor must advise the franchisee of the different formats in which the disclosure document is made available, including any prerequisites for obtaining the disclosure document in a particular format and any conditions necessary for viewing the disclosure document in a particular format.
- The disclosure document and agreements can be delivered electronically (via the franchisor’s website, e-mail, or CD-ROM). The franchisee must be able to store, download, print, or otherwise maintain the documents. Navigation tools, such as scroll bars, internal links, and search features, are permitted. No audio, video, pop-up screens, or external links are allowed.
- The cover page of the disclosure document must include the franchisor’s e-mail address and website. The Franchise Rule also permits franchisors to state on the cover page the different ways that franchisees may receive a copy of the disclosure document, including electronically.

### *Execution*

- Signatures can be handwritten or use security codes, passwords, electronic signatures, and similar devices through which a person’s identity can be authenticated.

## Changes to the content of the disclosure document

### *Related companies*

- The disclosure document must identify direct and indirect parent companies, and may be required to provide litigation and bankruptcy disclosure regarding parent companies, as described below.

### *Business experience*

- In a significant simplification, brokers no longer must be identified in the Franchise Disclosure Document.

### *Litigation*

- The amended Franchise Rule significantly expands the required litigation disclosures, to include: (1) all material lawsuits involving the franchise relationship in the last fiscal year, filed by or against (a) a franchisor, (b) a franchisor's parent company that promises to back the franchisor financially or otherwise guarantees the franchisor's performance, or (c) a franchisor's affiliate that either offers franchises under the franchisor's principal trademark or promises to back the franchisor financially or otherwise guarantees the franchisor's performance; and (2) certain pending and past litigation against such parent or affiliate.
- The disclosures described above are significantly more broad than the current Franchise Rule, which does not require disclosure of lawsuits initiated by the franchisor and limits the disclosure of lawsuits against the franchisor to those that allege a violation of a franchise, antitrust, or securities law; fraud; unfair or deceptive practices; or comparable allegations.

### *Bankruptcy*

- The amended Franchise Rule has added disclosure of bankruptcy history of any parent company.

### *Restrictions on suppliers*

- Under the amended Franchise Rule, a franchisor must disclose whether an officer of the franchisor owns an interest in any approved supplier.

### *Computer systems*

- The amended Franchise Rule requires less-detailed disclosure regarding a franchisor's computer requirements. A franchisor is no longer required to identify each and every required piece of hardware and software by brand, type, and principal function, or to identify compatible equivalents and whether they have been approved by the franchisor.

### *Territory*

- Under the amended Franchise Rule, a franchisor must disclose whether the franchisor or an affiliate has used, or has the right to use, other channels of distribution, such as the Internet, catalog sales, telemarketing, or other direct marketing sales, to make sales within the franchisee's territory, using either the franchisor's principal trademarks or trademarks different from the ones the franchisee is granted the right to use.

### *Confidentiality clauses and agreements*

- The amended Franchise Rule requires disclosure of a franchisor's use of confidentiality clauses that prohibit or restrict existing or former franchisees from discussing their experience with prospective franchisees.

### *Franchisee associations*

- Franchisee associations must be disclosed in the disclosure document if they are sponsored, created, or endorsed by the franchisor or if they are incorporated or otherwise organized under state law and request to be included within 60 days of the close of the franchisor's fiscal year-end.

### *Summary of outlets*

- In a significant set of changes that will affect all franchisors, the table of data that shows how many franchises in each of the last three years were terminated, sold, or transferred has been changed to avoid the "double-counting" problem. The definitions of each category have been expanded to avoid any overlap, and Item 20 will now have five separate tables, including a separate table for transfers.
- One of the new tables requires a breakdown of how many company-owned outlets opened, closed, were acquired from franchisees, or were sold to franchisees during the franchisor's last three fiscal years.
- Significantly, under the amended Franchise Rule if a franchisor is selling a previously franchised outlet that is currently under the franchisor's control, the franchisor must provide the prospective franchisee with a supplemental disclosure that lists the name, address, and phone number of each previous owner of the outlet during the last five years, the reason for each change in ownership, and certain additional information.

### *Financial statements*

- Financial statements may be prepared in accordance with non-United States GAAP (Generally Accepted Accounting Principles), but only as now permitted by the Securities and Exchange Commission (SEC). SEC requirements currently include the inclusion of a reconciliation of the foreign statements to U.S. GAAP.
- Start-up franchises are not required to provide audited financials for their first partial or full fiscal year operating as a franchise.

### *Annual renewal*

- Annual updates to the disclosure document must be made within 120 days after the end of the franchisor's fiscal year; formerly, the requirement was 90 days.

### *Financial performance representations ("Earnings claims")*

- Earnings claims, which are referred to in the amended Franchise Rule as "financial performance representations," must be made in Item 19 of the disclosure document itself, not in a separate document attached to the disclosure document.

- The amended Franchise Rule eliminates the requirement that any historical financial performance claims must be based upon GAAP.
- There is new required “preamble” language that must be included as to whether financial performance representations are made.

### **Conclusion/Open issues**

- The amended Franchise Rule constitutes a long-overdue, major overhaul of the original 1978 Franchise Rule.
- The amended Franchise Rule provides practical solutions to long-standing problems, inconsistencies, and inefficiencies that existed in the original Franchise Rule.
- By adopting the UFOC disclosure format (with some changes), the FTC becomes the governing body that will now have authority to interpret the new UFOC guidelines.
- The amended Franchise Rule does not become effective until July 1, 2007, and is not mandatory until July 1, 2008, providing sufficient time for franchisors to become informed and revise their disclosure documents.
- The FTC Staff intends to prepare a Compliance Guide by July 1, 2007, that focuses on the changes to the FTC Rule. The Staff is accepting suggestions for interpretive issues that should be included in the Compliance Guide.
- The amended Franchise Rule raises a variety of issues – for example, exactly how will the states adopt the amended Franchise Rule and when will they implement it? Will all the states implement the amended Franchise Rule, or will there be individual state differences?

*This Franchise Alert was prepared by Christopher Wallace, Kendal Tyre, and Andrew Loewinger in the Washington, D.C., office and Emily Chang in the San Francisco office.*

### **References**

*Federal Trade Commission*

<http://ftc.gov>

*Federal Trade Commission – Text of the original Franchise Rule (16 C.F.R. Part 436)*

<http://ftc.gov/bcp/franchise/16cfr436.htm>

*Federal Trade Commission – Unofficial text of the new Franchise Rule*

<http://www.ftc.gov/opa/2007/01/franchiserule.htm>

*Federal Trade Commission – Consumer Information, Franchise, and Business Opportunities*

<http://ftc.gov/bcp/menu-fran.htm>

*North American Securities Administrators Association*

<http://nasaa.org>

*Uniform Franchise Offering Circular Guidelines*

[www.nasaa.org/content/Files/UniformFranchiseOfferingCircular.doc](http://www.nasaa.org/content/Files/UniformFranchiseOfferingCircular.doc)

## Franchise and Distribution Team

Please feel free to call or e-mail (emailname@nixonpeabody.com) any of the attorneys in our Franchise and Distribution Team listed below.

ATTORNEY	E-MAIL NAME	PHONE
WASHINGTON, DC		
Andrew P. Loewinger	aloewinger	202-585-8855
Kendal H. Tyre	ktyre	202-585-8368
Christopher J. Wallace	cwallace	202-585-8166
BOSTON		
Arthur L. Pressman	apressman	617-345-1158
Amy R. George	ageorge	617-345-1143
Gregg A. Rubenstein	grubenstein	617-345-6184
Daniel J. Ryan	dryan	617-345-1069
SAN FRANCISCO		
Jay H. Begler	jbegler	415-984-8287
Emily S. Chang	echang	415-984-8285
Bruce E. Copeland	bcopeland	415-984-8253
Glenn E. Westreich	gwestreich	415-984-8331
ROCHESTER, NY		
Robert B. Calihan	rcalihan	585-263-1475
Peter H. Durant	pdurant	585-263-1227
Carolyn G. Nussbaum	cnussbaum	585-263-1558
Andrew P. Zappia	azappia	585-263-1214
PHILADELPHIA		
Craig R. Tractenberg	ctractenberg	215-246-3525
Renée Bergmann	rbergmann	215-246-3524
NEW YORK CITY		
Frank W. Ryan	fryan	212-940-3129
MANCHESTER, NH		
Jamie N. Hage	jhage	603-628-4074
BUFFALO, NY		
Mark A. Molloy	mmolloy	716-853-8132

### **Boston, MA**

100 Summer Street  
617-345-1000

### **Los Angeles, CA**

555 West Fifth Street, FL 46  
213-533-1050

### **New York, NY**

437 Madison Avenue  
212-940-3000

### **Rochester, NY**

1100 Clinton Square  
585-263-1000

### **San Francisco, CA**

Two Embarcadero Center  
415-984-8200

### **Washington, DC**

401 Ninth Street NW, Suite 900  
202-585-8000

### **Albany, NY**

30 South Pearl Street  
518-427-2650

### **Buffalo, NY**

40 Fountain Plaza, Suite 500  
716-853-8100

### **Hartford, CT**

185 Asylum Street  
860-275-6820

### **Long Island, NY**

50 Jericho Quadrangle, Suite 300  
516-832-7500

### **Manchester, NH**

900 Elm Street  
603-628-4000

### **McLean, VA**

2010 Corporate Ridge, Suite 700  
703-827-8095

### **Palm Beach Gardens, FL**

4400 PGA Boulevard, Suite 900  
561-626-3011

### **Philadelphia, PA**

1818 Market Street, FL 11  
215-246-3520

### **Providence, RI**

One Citizens Plaza  
401-454-1000

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