

**SUMMARY OF THE  
NEW FEDERAL TRADE COMMISSION  
RULE ON FRANCHISING**

***FISHERZUCKER LLC***  
**21 South 21<sup>st</sup> Street**  
**Philadelphia, PA 19103**  
**215-825-3130**  
**[www.fisherzucker.com](http://www.fisherzucker.com)**  
**[www.updatemyufoc.com](http://www.updatemyufoc.com)**

## **THE NEW FEDERAL TRADE COMMISSION RULE ON FRANCHISING**

The New Federal Trade Commission Rule on Franchising (the “New FTC Rule”) was approved on January 22, 2007 and goes into effect on a voluntary basis on July 1, 2007. Compliance with the New FTC Rule becomes mandatory on July 1, 2008. This paper hopes to explain the differences between the New FTC Rule and prior practice as required by the original Federal Trade Commission Rule on Franchising (the “Original FTC Rule”) and the Uniform Franchise Offering Circular (“UFOC”) Guidelines.

### **FTC COVER PAGE**

The New FTC Rule substantially amends the Original FTC Rule’s cover page to require a brief description of the business(es) being franchised, the total estimated initial investment to start up a franchise, and initial franchise fees due. In addition, the New FTC rule allows franchisors to provide prospects with notice that the Franchise Disclosure Document, as it is now called, may be available in electronic format. The final rule permits franchisors to include state mandated risk factors on the FTC cover page without expressly adopting those risk factors.

### **NASAA STATE COVER PAGE**

Despite the seeming open invitation to include North American Securities Administrators Association (“NASAA”) and state-mandated risk factors on the FTC cover page, NASAA has endorsed a separate state cover page to immediately follow the New FTC Rule’s cover page, which includes the two risk factors not adopted under the New FTC rule regarding choice of venue and choice of law. The NASAA cover page for franchise disclosure documents differs from the UFOC Guidelines in that it requires additional disclosures regarding the relationship between the franchisor and any brokers it may have. The NASAA cover page also requires franchisors to include an additional risk factor notifying the franchisee (where applicable) that the franchisee may be required to enter into materially different franchise agreements upon renewal.

### **ITEM 1** **THE FRANCHISOR AND ANY PARENTS, PREDECESSORS, AND** **AFFILIATES**

The New FTC Rule’s Item 1 disclosure requirements parallel those of the UFOC Guidelines, and may be classified into five categories: (a) franchisor disclosures; (b) parent disclosures; (c) affiliate disclosures; (d) predecessor disclosures; and (e) disclosures about the franchise being offered.

## **Franchisor Disclosures**

A franchisor is defined as “any person who grants a franchise and participates in the franchise relationship,” and includes subfranchisors. A subfranchisor is “any person who functions as a franchisor by engaging in presale activities and post-sale performance.”<sup>1</sup>

As required under the Original FTC Rule, the franchisor must disclose:

- (a) The name and principal business address of the franchisor,<sup>2</sup> as well as its type of business organization, date of organization, and state of organization;
- (b) The name under which the franchisor intends to conduct its business;
- (c) Whether the franchisor operates a business of the type being franchised and, if so, the length of time the franchisor has operated such a business;
- (d) The franchisor’s other business activities; and
- (e) The name and principal business address of the franchisor’s agent(s) for service of process.

In addition, the franchisor must also disclose whether it has offered franchises in any other line of business. As required under the UFOC Guidelines, if the franchisor has offered franchises in any other line of business, Item 1 must contain:

- (a) A description of the other line of business;
- (b) The number of franchises sold in the other line of business;
- (c) The length of time the franchisor has offered franchises in the other line of business.<sup>3</sup>

## **Parent Disclosures**

The franchisor must disclose the name and principal business address of its parent. A parent is defined as “an entity that controls another entity directly, or indirectly through one or more subsidiaries.”<sup>4</sup> The focus of the disclosure obligation is not dependent upon percentage ownership, but actual control.<sup>5</sup> Therefore, even if an entity owning less than 50% of a franchisor exerts control over it, that parent’s information

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<sup>1</sup> 16 CFR 436.1(k). In its Statement of Basis and Purpose, at Article III (A)(11), footnote 172, the FTC cites to Illinois and California’s Franchise Acts as informing its definition of a subfranchisor.

<sup>2</sup> 16 CFR 436.3(a)(1).

<sup>3</sup> 16 CFR 436.3(a)(7).

<sup>4</sup> 16 CFR 436.1(m).

<sup>5</sup> 16 CFR 436 Statement of Basis and Purpose, Article III, Section A13.

must be disclosed in Item 1. In addition, because parents may also constitute affiliates of the franchisor, where parents offer franchises in any line of business or offer products or services to franchisees, the affiliate disclosures discussed below will apply.

### **Affiliate Disclosures**

An affiliate is defined as “an entity controlled by, controlling, or under common control with another entity.”<sup>6</sup> The New FTC Rule limits the franchisor’s Item 1 disclosure obligations to those affiliates who “offer franchises in any line of business or who provide products and services” to system franchisees. The franchisor must disclose the name and business address of each affiliate who offers franchises in any line of business or who provides products or services to system franchisees. For each such affiliate, the franchisor must disclose:

- (a) The length of time the affiliate has operated a business of the type that is being franchised; and
- (b) The length of time the affiliate has offered franchises for similar types of business.

If the affiliate offers franchises in any other line of business, the franchisor must disclose a description of that other line of business, the number of franchises sold in the other line of business, and the length of time the affiliate has offered franchises in each other line of business.<sup>7</sup>

### **Predecessor Disclosures**

As in the UFOC Guidelines, the New FTC rule defines a predecessor as a “a person from whom the franchisor acquired, directly or indirectly, a major portion of the franchisor’s assets.”<sup>8</sup> The franchisor must disclose the name and principal business address of all predecessors during its past 10 fiscal years. The franchisor must also disclose such predecessors’ business activities, including:

- (a) The length of time the predecessor has operated a business of the type that is being franchised; and
- (b) The length of time the predecessor has offered franchises for similar types of business.

If any predecessor over the past 10 fiscal years offers franchises in any other line of business, the franchisor must disclose a description of the other line of business, the number of franchises sold in the other line of business, and the length of time the predecessor has offered franchises in each other line of business.

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<sup>6</sup> 16 CFR 436.1(b).

<sup>7</sup> 16 CFR 436.3(a)(7)(iii).

<sup>8</sup> 16 CFR 436.1(p).

## **Disclosures About the Franchise**

The New FTC Rule, like the UFOC guidelines, requires the franchisor to provide a description of the franchise being offered. In addition, the franchisor must disclose the general market for the products or services the franchisee will be offering, including:

- (a) Seasonality;
- (b) Whether the market for the franchised system's goods or services is developed or developing; and
- (c) Whether the goods or services will be sold primarily to a certain group.

Finally, the franchisor must provide a general description of competitors and laws or regulations specific to the industry in which the franchised business operates.

## **ITEM 2** **BUSINESS EXPERIENCE**

As required under the Original FTC Rule and the UFOC guidelines, franchisors must disclose each of their “directors, trustees, general partners, and principal officers,”<sup>9</sup> by name and position, and provide their employment history over the past five years. For each position held, the franchisor must disclose the employer, location of employment, and start and end dates at each job, as well as the position held at each job. However, the New FTC Rule differs from the existing UFOC Guidelines and the Original FTC Rule in two material respects. First it does not require broker disclosures. Secondly, it expands the Item 2 disclosure obligations to any individuals holding management responsibility relating to the sale or operation of franchises.

### **Persons Holding Management Responsibility**

The New FTC Rule requires franchisors to disclose the five-year employment history of any persons having “management responsibility relating to the sale or operation of franchises.” Hence, the franchisor must disclose the experience, or lack thereof, of any person having control over the way the franchisor performs its obligations under franchise agreements. Conversely, disclosures regarding prior experience of a parent's officers and directors were expressly excluded.

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<sup>9</sup> 16 CFR 436.5(b).

## **Brokers**

The New FTC Rule also departs from the UFOC Guidelines in that it does not require broker disclosures. The FTC reasoned that broker expertise or background information would carry little weight to prospective franchisees because brokers do not “create or implement franchisor policy” or “oversee performance of post-sale obligations to the franchisee.”<sup>10</sup> Moreover, the FTC found that the informative value of the broker disclosures was outweighed by the burden on franchisors in compiling and disclosing broker information. Finally, the FTC noted that brokers would still be liable under Section 5 of the FTC Act for making false claims or misrepresentations in relation to the offer or sale of franchises in interstate commerce. Therefore, broker disclosures are no longer required.

## **ITEM 3 LITIGATION**

The New FTC Rule retains the Original FTC Rule and UFOC Guideline’s requirements to disclose certain items of litigation. However, it has expanded the disclosure requirements to previously exempt entities and now requires the disclosure of material items of franchisor-initiated litigation. Notably, injunctive decree disclosures will apply to both affiliates who offer franchises using the franchisor’s trademarks and affiliates who have offered franchises in any line of business within the past ten years. Unlike under the Original FTC Rule, the New FTC rule requires parental disclosures where the parent “induces franchise sales by promising the back the franchisor financially or otherwise guarantees the franchisor’s performance.”<sup>11</sup> Also, as required under the UFOC Guidelines, franchisors must disclose any payments made as part of settlement agreements, regardless of whether they are “confidential” or not. A detailed discussion of disclosure obligations follows.

### **All Material Civil Actions, Including Franchisor-Initiated Litigation**

The New FTC Rule differs from both the Original FTC Rule and the UFOC Guidelines in that it requires franchisors to disclose certain franchisor-initiated litigation during the prior year. Specifically, the text of the rule requires the franchisor to disclose, “any material civil action involving the franchise relationship”<sup>12</sup> in the last fiscal year. Actions involve the franchise relationship if they relate to the parties’ contractual obligations (such as royalties and training obligations). Actions involving suppliers or third parties, or indemnification for tort liability are specifically excluded from the material civil action requirement.<sup>13</sup> The FTC found franchisor-initiated litigation is important because it informs prospects of the nature of disputes and the level of litigation

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<sup>10</sup> 16 CFR 436, Statement of Basis and Purpose at Article III(C)(4)(a).

<sup>11</sup> 16 CFR 436.5(c)(1).

<sup>12</sup> 16 CFR 436.5(c)(1)(ii).

<sup>13</sup> 16 CFR 436.5(c)(1)(ii).

within the system.<sup>14</sup> By limiting such disclosures to a one-year period, however, the FTC hopes to ease the burden on franchisors.

This disclosure obligation extends to:

- (a) The franchisor;
- (b) Any parent or affiliate guaranteeing the franchisor's obligations;
- (c) Any affiliate who uses the franchisor's trademarks; and
- (d) Any predecessor.

It does not, however, extend to litigation involving another franchise system owned by the franchisor or litigation involving affiliates and third party suppliers.

For any franchisor-initiated suit, the franchisor may list individual suits under a common heading, as opposed to giving detailed information about each action (such as the case number, court, and filing date information otherwise required).<sup>15</sup>

### **Injunctive Decrees**

The franchisor is now required to disclose whether the following entities are subject to any currently effective injunctive or restrictive order or decree resulting from pending or concluded action brought by a public agency relating to the franchise or to any Federal, Canadian, or state securities, antitrust, trade regulation or trade practice law:

- (a) Any parent who guarantees franchisor's performance;
- (b) Any affiliate who either guarantees the franchisor's obligations or who has offered or sold franchises within the past 10 years; and
- (c) Any Item 2 director, trustee, general partner, principal officer, or other person with management responsibility over the franchise.<sup>16</sup>

For all matters of injunctive relief, the franchisor must disclose the nature, terms, and conditions of the order(s) or decree(s).

### **Pending Litigation:**

The franchisor must disclose whether the franchisor, its predecessors, parents or affiliates who guarantee its obligations, or affiliates who use its marks to offer or sell franchises have pending against them any:

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<sup>14</sup> 16 CFR 436.5; Statement of Basis and Purpose, Article II, Section 5(d).

<sup>15</sup> 16 CFR 436.5(c)(4).

<sup>16</sup> 16 CFR 436.5(c)(2).

- (a) Administrative criminal, or material civil litigation alleging a violation of a franchise, antitrust, or securities law, or alleging fraud, unfair or deceptive trade practices, or comparable litigation;
- (b) Civil actions, other than ordinary routine litigation incidental to the business, which are material in the context of:
  - (i) The number of franchisees; and
  - (ii) The size, nature, or financial condition of the franchise system or its business operations.<sup>17</sup>

For all pending actions, the franchisor must disclose the date current status of the action.

### **Prior Litigation**

The franchisor must disclose whether the franchisor, predecessor, any parent or affiliate who guaranteed its obligations, or any affiliate who uses its trademarks to offer or sell franchises, have, within a 10 year period prior to the issuance of the UFOC:

- (a) Been convicted of or pleaded nolo contendere to a felony charge;
- (b) Have been held liable in any civil action involving a violation of a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive trade practices, or comparable allegations.

With regards to prior civil litigation involving franchise or related laws, the franchisor is only required to disclose such items of litigation if the franchisor had to pay money or other consideration, or reduce indebtedness by the amount of an award, take actions adverse to its interest, or otherwise forebear from exercising its rights. Actions, which were dismissed or settled favorably, need not be disclosed.

For all convictions or pleas, the crime or violation, the date of conviction, and the sentence or penalty imposed must be disclosed.

### **Settlement**

Consistent with the UFOC Guidelines, the New FTC Rule requires franchisors to disclose any material civil actions, including those that were settled confidentially.<sup>18</sup> As stated in the New FTC Rule, if a settlement agreement must be disclosed, all material settlement terms must be disclosed, whether or not the agreement is confidential. Settlements favorable to or otherwise neutral with respect to the franchisor need not be

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<sup>17</sup> 16 CFR 436.5(c)(1)(i).

<sup>18</sup> 16 CFR 436.5(c)(3), Footnote 2.

disclosed.<sup>19</sup> Franchisors need not disclose confidential settlements entered into prior to the effective date of the New FTC Rule. Moreover, franchisors need not disclose the terms of confidential settlements entered into prior to commencing franchise sales.<sup>20</sup>

### **Disclosure Format**

As required under the UFOC Guidelines, for all actions except franchisor-initiated actions, the franchisor must disclose:

- (a) Title, case number or citation;
- (b) The parties and the relationship of the opposing party to the franchisor;
- (c) The legal and factual nature of each claim in the action; and
- (d) The relief sought and/or obtained.

### **ITEM 4** **BANKRUPTCY**

The new FTC Rule's Item 4 requirements mirror those of the UFOC Guidelines, with a few minor exceptions. The New FTC Rule extends Item 4 disclosures to any bankruptcy actions in which the franchisor either filed a petition or obtained a discharge of debts during the 10-year period immediately before the UFOC's issuance date. The franchisor must disclose whether it, any parent, predecessor, affiliate, or person having management responsibility relating to the sale or operation of the franchise offered has:

- (a) Filed as a debtor in a petition under the US bankruptcy Code;
- (b) Obtained a discharge of debts under the Bankruptcy Code; or
- (c) Was a principal officer of a company or general partner in a partnership that either filed as debtor or obtained a discharge of debts within one year after the person held a position with the filing the petition or obtaining the discharge.

Bankruptcy disclosures apply to all affiliates and parents, whether or not they guarantee the franchisor's obligations. They also apply to predecessors. The New FTC Rule includes persons with management responsibility over the franchise, and also applies to foreign proceedings comparable to United States bankruptcy filings.

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<sup>19</sup> 16 CFR 436.5; Statement of Basis and Purpose, Article II, Section 5(c).

<sup>20</sup> 16 CFR 436.5(c)(3), Footnote 2.

**ITEM 5**  
**INITIAL FEES**

The New FTC Rule requires the disclosure of all initial fees that a franchisee becomes obligated to pay directly to the franchisor or any affiliate prior to opening. The New FTC Rule still follows the UFOC Guidelines in explicitly permitting franchisors to provide a range of fees. The main differences between the New FTC Rule and the Original FTC Rule lies in the title of Item 5, with the New FTC Rule using the term “Initial Fees” as opposed to the Original FTC Rule’s term “Initial Franchise Fee”. References to “fee” in the New FTC Rule have been revised as follows: (1) “these fees are refundable,” in place of “this fee is refundable;” and (2) “Initial fees mean,” in place of “initial fee means.”

As such, the New FTC Rule recognizes not just fees that are actually paid, but commitments to pay Franchisor and its affiliates at a later date.<sup>21</sup>

**ITEM 6**  
**OTHER FEES**

Substantially similar to the UFOC Guidelines, the New FTC Rule’s Item 6 requires disclosure of fees paid directly to the franchisor or its affiliates; or collected by the franchisor or its affiliates for the benefit of a third party. In this item, Franchisors must explicitly state what fees are non-refundable (rather than just stating the conditions where a fee is refundable).

**ITEM 7**  
**INITIAL INVESTMENT**

Consistent with the UFOC Guidelines, the New FTC Rule requires franchisors to disclose the initial investments during the start-up phase of the franchised business (a period of at least three months). Costs to be listed include the initial franchise fee and training fee, if any, equipment and inventory expenses, security deposits, expenses related to obtaining real property, and any additional funds required during the start-up phase.

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<sup>21</sup> For example, a commitment to pay at a future date would include an initial franchisee fee that is deferred into a promissory note. Despite the fact is not “paid” prior to entering into the franchise agreement, it is still an initial fee.

## **ITEM 8** **RESTRICTIONS ON SOURCES OF PRODUCTS AND SERVICES**

Similar to Item 8 of the UFOC Guidelines, the New FTC Rule's Item 8 requires certain disclosures of franchisee purchase restrictions.

### **1. Requirements**

Specifically, the franchisor must disclose the franchisee's obligations to purchase or lease goods, services, fixtures, equipment, real estate, or comparable items related to establishing or operating the franchised business either from the franchisor, its affiliates, or suppliers approved of or designated by the franchisor, or under the franchisor's specifications.<sup>22</sup> The disclosure should include obligations to purchase imposed by written agreement or by the franchisor's practice.<sup>23</sup>

The New FTC Rule requires franchisors to disclose whether they make criteria for approving suppliers available to franchisees.<sup>24</sup> In addition, franchisors must state whether, by contract or practice, the franchisor provides material benefits to franchisees that use designated or approved suppliers (e.g. permitting renewals or additional outlets). The New FTC Rule also requires franchisors to disclose the existence of purchasing or distribution cooperatives, and whether the franchisor negotiates purchase agreements with suppliers on behalf of franchisees.

Finally, franchisors are also required to disclose revenues earned by themselves or their affiliates from franchisee purchases, and the basis for that revenue, including any rebates or commissions received from approved and designated suppliers. Franchisors must disclose the revenue generated from required franchisee purchases in dollar amounts, and as a percentage of overall revenue.

### **2. Differences from the Original FTC Rule**

The New FTC Rule more closely resembles the UFOC Guidelines for Item 8. While the Original FTC Rule required franchisors to disclose obligatory purchases, restrictions on sources of products and services, and the amount of any revenue the franchisor may receive, the New FTC Rule requires more detailed and extensive disclosures on these topics, consistent with the UFOC Guidelines. The New FTC Rule differs from the UFOC Guidelines in that franchisors are now required to disclose their ownership interest in any approved or designated suppliers.

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<sup>22</sup> 64 FR at 57336.

<sup>23</sup> Franchisors may include the reason for the requirement. Franchisors are not required to disclose in this Item the purchase or lease of goods or services provided as part of the franchise without a separate charge (e.g., initial training, the cost of which is included in the franchise fee); such fees should be described in paragraph (e) of this section. Franchisors should not disclose fees already described in paragraph (e) of this section.

<sup>24</sup> 64 FR at 57336; 16 CFR 436.5(h).

Consistent with the UFOC Guidelines in Item 8, the New FTC Rule requires franchisors to disclose a general description of their selection criteria. The FTC agreed that full disclosure of source restrictions and purchasing obligations is warranted but it is possible to warn prospective franchisees without requiring franchisors to disclose their past practices regarding approving alternative suppliers or their future intentions, which may be proprietary information or misleading if the franchisor abandons the intended direction.

## **ITEM 9** **FRANCHISEE'S OBLIGATIONS**

In Item 9 of the New FTC Rule, franchisors must disclose in a tabular form a list of franchisees' principal obligations. The rule was adopted in whole from the UFOC Guidelines and has no counterpart in the Original FTC Rule.<sup>25</sup>

Franchisors must disclose in the tabular form set forth in the UFOC Guidelines, a list of the franchisees' principal obligations. This disclosure gives prospective franchisees an easy-to-understand guide to 25 enumerated contractual obligations that are common in franchise relationships, with cross references to the specific sections of the franchise agreement and disclosure document that discuss each obligation in greater detail. To the extent that legal obligations are spelled out in any ancillary agreements, franchisors must direct prospects to those provisions as well.<sup>26</sup>

## **ITEM 10** **FINANCING**

Consistent with the UFOC Guidelines' Item 10, the New FTC Rule requires a franchisor to disclose all of the material terms and conditions of any financing agreements.

### **1. Differences from the Original FTC Rule**

The New FTC Rule is comparable to the Original FTC Rule. However, it extends the Original FTC Rule disclosures by requiring franchisors to disclose:<sup>27</sup>

- (a) Any interest on the financing in terms of the rate of interest, plus finance charges, expressed on an annual basis, consistent with such disclosures required in consumer credit transactions.

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<sup>25</sup> 16 CFR 436.5(i)

<sup>26</sup> *Id.*

<sup>27</sup> 16 CFR 436.1(a)(12).

- (b) It also requires more disclosure than the Original FTC Rule about what the financing covers, waiver of defenses, and the franchisor's practice or intent to sell or assign the obligation to a third party.<sup>28</sup>

## 2. **Differences from the UFOC Guidelines**

The New FTC Rule differs from the UFOC Guidelines in that the express reference to the Consumer Credit Protection Act's Truth in Lending ("TILA") provisions, 15 U.S.C. 1605-1606, have been removed. While not intending to depart unnecessarily from the UFOC Guidelines, the Commission believed that this reference could potentially confuse prospects because TILA may not apply to all of the transactions within the scope of the New FTC Rule. Nevertheless, franchisors can look to TILA and to the Consumer Leasing Act for guidance in crafting their disclosures under Item 10.<sup>29</sup>

### **ITEM 11** **FRANCHISOR'S ASSISTANCE, ADVERTISING, COMPUTER SYSTEMS, AND TRAINING**

Item 11 of the New FTC Rule deals with franchisors' disclosure obligations as they relate to initial and ongoing operational assistance, the creation and management of national and regional advertising funds and cooperatives, computer systems, and training. While modeled substantially on Item 11 of the UFOC Guidelines, it contains certain additional disclosures, as described below.

#### 1. **Differences from the Original FTC Rule**

The New FTC Rule retains the Original FTC Rule's disclosure of franchisor's assistance obligations, including pre-opening assistance (e.g. site selection, initial training), as well as ongoing assistance (e.g. ongoing training).<sup>30</sup> The New FTC Rule expands the Original FTC Rule based upon the UFOC Guidelines' more detailed assistance disclosure requirements, including:

- (a) Disclosures relating to advertising assistance and the operation of local, regional and national advertising councils or co-ops.
- (b) An obligation to "describe the systems which includes hardware and software components) generally in non-technical language, including the types of data to be generated or stored in these systems."<sup>31</sup>

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<sup>28</sup> Federal Register, Vol. 72, No. 61 (March 20, 2007), Rules and Regulations p. 15489.

<sup>29</sup> *Id.* fn. 469.

<sup>30</sup> 16 CFR 436.1(a)(17), (18).

<sup>31</sup> 16 CFR 436.5(k).

- (c) Disclosures relating to site selection criteria and the franchisor's training program.
- (d) Whether the franchisor provides approved items directly to the franchisee or designates suppliers.
- (e) Whether the franchisor provides assistance in setting prices.
- (f) Whether the franchisor provides assistance in resolving franchisees' operational problems.
- (g) Whether the franchisor will develop any additional or improved products or services for franchisees to offer through their businesses.

Item 11 disclosures should begin with the following statement: "Except as listed below, [the franchisor] is not required to provide any assistance to you."

## 2. Differences from the UFOC Guidelines

The New FTC Rule differs from the UFOC Guidelines in two material respects. First, the Commission held that the computer usage disclosures set forth in the UFOC Guidelines go way beyond what is material in some instances and likely would impose unwarranted compliance burdens. Therefore, the New FTC Rule does not require franchisors to identify each and every 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.

The New FTC Rule also amends franchisors' obligations with respect to the operations manual. Under the UFOC Guidelines, franchisors were required to include the table of contents to any operations manuals in the disclosure document unless "the prospective franchisee views the manual before the purchase of the franchise."<sup>32</sup> The New FTC Rule, at most, requires franchisors to afford a prospective franchisee *the opportunity* to review the manual. The "opportunity to review" a manual must be a reasonable one.<sup>33</sup>

## **ITEM 12** **TERRITORY**

Item 12 of the New FTC Rule retains the Original FTC Rule's disclosures concerning exclusive territories and sales restrictions, but it is more closely modeled on the UFOC Guidelines, and therefore expands the Original FTC Rule's disclosure requirements.

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<sup>32</sup> UFOC Guidelines, Item 11, at B. vii).

<sup>33</sup> A franchisor would not meet its obligation if, for example, it offered to show a manual to a prospect only if the prospect agreed to fly across country to the franchisor's corporate headquarters.

## 1. Differences from the Original FTC Rule

The New FTC Rule more closely resembles the UFOC Guidelines in its Item 12 requirements. Accordingly, it expands the Original Rule's disclosure requirements regarding territories in several respects. Specifically, the New FTC Rule Statement of Basis and Purpose identifies that these new disclosure requirements cover:

- (a) The conditions, if any, under which a franchisor will approve the relocation of the franchisee's business and the franchisee's establishment of the additional outlets;
- (b) Any present plans on the part of the franchisor to operate a competing franchise system offering similar goods or services; and
- (c) In instances when a franchisor does not offer an exclusive territory, a prescribed warning about the consequences of purchasing a non-exclusive territory.

Additionally, the New FTC Rule also addresses new technologies and market developments, such as the Internet and alternative channels for distributing a franchisor's goods. Specifically, the New FTC Rule extends the Original Rule by providing a prospective franchisee with material information about competition not only through outlets within the prospective franchisee's intended location, but through alternative channels of distribution, such as the Internet, catalog sales, telemarketing, and direct marketing. In the same vein, it addresses any restrictions on a franchisee's ability to conduct business outside of his or her territory through traditional sales and sales through alternative channels of distribution.

The New FTC Rule also substitutes the words "location" or "exclusive territory" for "market area," "area," and "defined" area. The New FTC Rule Statement of Basis and Purpose states that terms such as "market area" and "defined area" are potentially misleading. Such terms inaccurately imply an inherent right to a territory, where in fact, the right to a territory, protected or otherwise, is purely a matter of contract. Accordingly, the term "exclusive territory" is more precise.

## 2. Differences from the UFOC Guidelines

While the New FTC Rule, as it pertains to territory, generally reflects requirements set forth in the UFOC Guidelines, it does contain some additional requirements. First, if franchisors do not provide any territorial exclusivity, or if territorial exclusivity is in any way qualified by the reservation of certain rights, the franchisor must include the following legend in Item 12:

You will not receive 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.

In addition, the FTC has defined “other channels of distribution” to include the Internet, catalog sales, telemarketing and other direct marketing in an effort to keep Item 12 current with changes in technology and the market place. As a result, a franchisor must specifically disclose the rights the franchisor and franchisee each have relative to the use of these other channels of distribution.

### **ITEM 13** **TRADEMARKS**

Similar to the Original FTC Rule and the UFOC Guidelines, the New FTC Rule requires a franchisor to disclose each principal trademark to be licensed to the franchisee.

#### 1. Definition

For this Item, “Principal trademark” means the primary trademarks, service marks, names, logos, and commercial symbols the franchisee will use to identify the franchised business. It may not include every trademark the franchisor owns.

#### 2. Requirements

The New FTC Rule requires that a franchisor disclose whether each principal trademark is registered with the United States Patent and Trademark Office.

If the trademark is registered with the U.S. Patent and Trademark Office, franchisor must state:

- (i) The date and identification number of each trademark registration;
- (ii) Whether the franchisor has filed all required affidavits;
- (iii) Whether any registration has been renewed; and
- (iv) Whether the principal trademarks are registered on the Principal or Supplemental Register of the United States Patent and Trademark Office.

If the trademark is not registered on the Principal Register of the U.S. Patent and Trademark Office, the franchisor must state whether it has filed any trademark application, and, if so, whether the application is based on “intent to use” or actual use, as well as the date and serial number of the application.

Further, if the trademark is not registered on the Principal Register of the United States Patent and Trademark Office, the franchisor must state:

We do not have a federal registration for our principal trademark. Therefore, our trademark does not have as 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.

a. Current Effective Material Determinations

The franchisor must also disclose any currently effective material determinations of the United States Patent and Trademark Office, the Trademark Trial and Appeal Board, or any state trademark administrator or court; and any pending infringement, opposition, or cancellation proceeding. The franchisor must include infringement, opposition, or cancellation proceedings in which the franchisor unsuccessfully sought to prevent registration of a trademark in order to protect a trademark licensed by the franchisor and describe how the determination affects the ownership use, or licensing of the trademark.

b. Pending Material

A franchisor is required to disclose any pending material federal or state court litigation regarding the franchisor's use or ownership rights in a trademark. For each pending action, disclose:

- (i) The forum and case number;
- (ii) The nature of claims made opposing the franchisor's use of the trademark or by the franchisor opposing another person's use of the trademark; and
- (iii) Any effective court or administrative agency ruling in the matter.

c. Current Effective Agreements

A franchisor is required to disclose any currently effective agreements that significantly limit the franchisor's rights to use or license the use of trademarks listed in this section in a manner material to the franchise. For each agreement, disclose:

- (i) The manner and extent of the limitation or grant;
- (ii) The extent to which the agreement may affect the franchisee;
- (iii) The agreement's duration;
- (iv) The parties to the agreement;
- (v) The circumstances when the agreement may be canceled or modified; and
- (vi) All other material terms.

d. Franchisee's Rights and Obligations.

Under the New FTC Rule, the franchisor must disclose the following:

- (i) Whether the franchisor must protect the franchisee's right to use the principal trademarks listed in this section, and must protect the franchisee against claims of infringement or unfair competition arising out of the franchisee's use of the trademarks.
- (ii) The franchisee's obligation to notify the franchisor of the use of, or claims of rights to, a trademark identical to or confusingly similar to a trademark licensed to the franchisee.
- (iii) Whether the franchise agreement requires the franchisor to take affirmative action when notified of these uses or claims.
- (iv) Whether the franchisor or franchisee has the right to control any administrative proceedings or litigation involving a trademark licensed by the franchisor to the franchisee.
- (v) Whether the franchise agreement requires the franchisor to participate in the franchisee's defense and/or indemnify the franchisee for expenses or damages if the franchisee is a party to an administrative or judicial proceeding involving a trademark licensed by the franchisor to the franchisee, or if the proceeding is resolved unfavorably to the franchisee.
- (vi) The franchisee's rights under the franchise agreement if the franchisor requires the franchisee to modify or discontinue using a trademark.

e. Franchisor Knowledge of Infringement

Under the New FTC Rule, the franchisor must also disclose whether the franchisor knows of either superior prior rights or infringing uses that could materially affect the franchisee's use of the principal trademarks in the state where the franchised business will be located. For each use of a principal trademark that the franchisor believes is an infringement that could materially affect the franchisee's use of a trademark, the franchisor must disclose:

- (i) The nature of the infringement.
- (ii) The locations where the infringement is occurring.
- (iii) The length of time of the infringement (to the extent known).
- (iv) Any action taken or anticipated by the franchisor.

### 3. Differences from the Original FTC Rule

The New FTC Rule expands on the required disclosures that a franchisor must disclose in regards to trademarks. While the Original Rule only required a franchisor to list the trademark identifying the goods or service to be sold by the prospective franchisee, the New FTC Rule requires franchisors to disclose:

- (a) Whether the trademark is registered with the US Patent & Trademark Office;
- (b) The existence of any pending litigation, settlements, agreements, or superior rights that may limit the franchisee's use of the trademark; and
- (c) Any contractual obligations to protect the franchisees right to use the mark against claims of infringement or unfair competition.

The New FTC Rule's Statement of Basis and Purpose explains that one of the principal reasons that one may wish to purchase a franchise (as opposed to starting one's own business) is the right to use the franchisor's mark, which presumably creates an instant market for the franchisees' goods or services. For that reason, any pending litigation settlement restrictions, or other potential limitations on the use of the trademark are material because they will necessarily affect the value of the trademark to a prospective franchisee and ultimately may impact the franchisee's ability to continue operating the business.

### **ITEM 14** **PATENTS, COPYRIGHTS, AND PROPRIETARY INFORMATION**

The New FTC Rule's Item 14 adopts the UFOC Guidelines' requirement for disclosure of information about the franchisor's intellectual property.

There is no comparable provision in the Original Rule on patents, copyrights, and proprietary information. Under the New FTC Rule, franchisors are required to describe in general terms the types of intellectual property involved in the franchise and any legal proceedings, settlements, and restrictions that may impact the franchisee's ability to use such property.

In the new FTC Rule's Statement of Basis and Purpose, the Commission supports this addition, stating that restriction on the use of the franchisor's intellectual property are material because they not only may seriously diminish the value of the franchise, but could undermine the franchisee's ability to operate business. Further, Item 14 may improve the relationship between franchisors and franchisee's by preventing any misunderstanding about the value or use of the franchisor's intellectual property.

**ITEM 15**  
**OBLIGATIONS TO PARTICIPATE IN THE ACTUAL OPERATION OF THE**  
**FRANCHISED BUSINESS**

Item 15 revises the Original FTC Rule's to more closely track the UFOC Guidelines.

1. Differences from the Original FTC Rule

The New FTC Rule retains the original Rule requirement that franchisors disclose whether franchisees are required to participate personally in the direct operation of the franchisee, however, it expands on this point by requiring franchisors to disclose:

- (i) Participation obligations arising not only from the parties' franchise agreement, but from other agreements or as a matter of practice;
- (ii) Whether direct participation is recommended; and
- (iii) Any limitations on whom the franchisee can hire as a supervisor and any restrictions that the franchisee must place on his or her manager.

If the franchisee operates as a business entity, the franchisor must also disclose the amount of equity interest, if any, that the supervisor must have in the franchise.

2. Differences from the UFOC Guidelines

The New FTC Rule is identical to the UFOC Guidelines' Item 15.

**ITEM 16**  
**RESTRICTIONS ON WHAT THE FRANCHISEE MAY SELL**

Item 16 of the New FTC Rule retains the Original FTC Rule's disclosure on sales restrictions with some additional disclosures.

1. Requirements

Under the New FTC Rule, franchisors must disclose any franchisor-imposed restrictions or conditions on the goods or services that the franchisee may sell or that limit access to customers, including:

- (i) Any obligation on the franchisee to sell only goods or services approved by the franchisor.
- (ii) Any obligation on the franchisee to sell all goods or services authorized by the franchisor.
- (iii) Whether the franchisor has the right to change the types of authorized goods or services and whether there are limits on the franchisor's right to make changes.

## 2. Differences from the Original FTC Rule

The New FTC Rule retains the original Rule’s disclosures on sales restrictions but extends the original Rule by requiring a franchisor to disclose whether the franchisor has the right to change the types of goods or services authorized for sale, as well as any limits on the franchisor’s right to make such changes.

The New FTC Rule Statement of Basis and Purpose states that these added disclosures better enable a prospective franchisee to understand the extent to which the franchisor has the contractual right to control sales, which may directly affect the prospect’s ability to conduct business, its independence from the franchisor, and ultimately, its profitability.

## 3. Differences from the UFOC

The New FTC Rule is consistent with the UFOC Guidelines.

### **ITEM 17** **RENEWAL, TERMINATION, TRANSFER, AND DISPUTE RESOLUTION**

Item 17 of the New FTC Rule adopts the UFOC Guidelines’ requirement to summarize in tabular form 23 enumerated terms and conditions of a typical franchise agreement. This approach greatly streamlines the Original FTC Rule’s requirements.

#### 1. Requirements

The New FTC Rule requires a franchisor to disclose, in tabular form, a table that cross-references each enumerated franchise relationship item with the applicable provision in the franchise or related agreement.

The table is to be titled “THE FRANCHISE RELATIONSHIP” in capital letters and bold face type.

In the New FTC Item 17 table, the franchisor must briefly describe each contractual provision. If a particular item is not applicable, the franchisor must state “Not Applicable.” If the agreement is silent about one of the listed provisions, but the franchisor unilaterally offers to provide certain benefits or protections to franchisees as a matter of policy, use a footnote to describe the policy and state whether the policy is subject to change.

The franchisor must also address in the Summary column for Item 17(c) what the term “renewal” means for your franchise system, including, if applicable, a statement that franchisees may be asked to sign a contract with materially different terms and conditions than their original contract.

## 2. Differences from the Original FTC Rule

The New FTC Rule greatly streamlines the original Rule by requiring franchisors to detail the rights and obligations already spelled out in the franchise agreement, however, the New FTC Rule expands on the Original Rule by requiring disclosure pertaining to:

- (i) Dispute resolution, including any arbitration or mediation requirements;
- (ii) Forum-selection; and
- (iii) Choice of law provision disclosures.

Additionally, the New FTC Rule requires a franchisor to explain what “renewal” means. If applicable, the franchisor must state in the Summary column for Item 17(c) that renewing franchisees may be asked to sign a contract with materially different terms and conditions than their original contract. Many franchisors already include a reference to the need to sign a different agreement under their listing of renewal requirements, but this makes those that are silent in the franchise agreement state a disclaimer that the policy may change.

Whereas the original rule only requires 14 categories of terms and conditions, the New FTC rule requires 23.

## 3. Differences from the UFOC Guidelines

The New FTC Rule adopts UFOC Guidelines’ Item 17, which requires franchisors to summarize in tabular form 23 enumerated terms and conditions of a typical franchise relationship, such as the duration of the franchise agreement, rights and obligations upon expiration of the franchise agreement, post-term covenants not to compete, and assignment and transfer rights.

Additionally, the New FTC rule emphasizes the importance of explaining the franchisor’s renewal policy, including, if applicable, a statement of the specific obligations on a franchisee, in particular, if a franchisee may be asked to sign a contract with materially different terms and conditions than their original contract upon renewal.

## **ITEM 18** **PUBLIC FIGURES**

Item 18 of the New FTC Rule adopts the UFOC Guidelines with respect to the disclosure of public figures. The New FTC rule requires franchisors to disclose the involvement of a public figure in the franchise system, including his or her management responsibilities, total investment made in the franchise system, and compensation if any.

1. Definition

For purposes of this section, a public figure means a person whose name or physical appearance is generally known to the public in the geographic area where the franchise will be located.

2. Requirements

Under the New FTC Rule, a franchisor must disclose:

- (i) Any compensation or other benefit given or promised to a public figure arising from either the use of the public figure in the franchise name or symbol, or the public figure's endorsement or recommendation of the franchise to prospective franchisees.
- (ii) The extent to which the public figure is involved in the management or control of the franchisor. Describe the public figure's position and duties in the franchisor's business structure.
- (iii) The public figure's total investment in the franchisor, including the amount the public figure contributed in services performed or to be performed. State the type of investment (for example, common stock, promissory note).

3. Differences from the Original FTC Rule

The New FTC Rule is substantively similar to the comparable disclosure provision of the original rule (former Item 19) with only minor language changes for the sake of clarity and improved organization.

4. Differences from the UFOC Guidelines

The New FTC Rule on Public figures is consistent with the UFOC Guidelines format and requirements.

**ITEM 19**  
**FINANCIAL PERFORMANCE REPRESENTATIONS**

Item 19 represents some substantial changes to prior practice. First, the New FTC Rule uses the term "financial performance representation". The New FTC Rule's use of this term rather than the Original FTC Rule's term "earnings claim" recognizes that some industries, such as hotels, use variables other than earnings to measure performance, such as room occupancy rates.<sup>34</sup> Further, a franchisor must use franchisee data in presenting a financial performance representation.

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<sup>34</sup> See Franchise NPR, 64 FR at 57297; New FTC Rule Statement Basis and Purpose

## 1. Definition

The New FTC Rule defines the term “financial performance representation” to mean:

any representation, including any 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. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.<sup>35</sup>

### i. Cost and Expense Information

The Statement of Basis and Purpose for the New FTC Rule makes clear that the definition of financial performance representation is not intended to reach disclosures of expense information. The Commission’s view is that the mere disclosure of cost information does not constitute a financial performance representation triggering Item 19 disclosure obligations.<sup>36</sup> Thus, a franchisor can provide cost and expense information to a prospect without having to prepare an Item 19 financial performance representation.

### ii. General Media Claims

The new definition retains the Original FTC Rule provision governing the making of financial performance representations in the general media. However, the New FTC Rule Statement of Basis and Purpose states that it is not the intention of the Commission to include within the definition dissemination of financial information through SEC filings, or other representations made online or in press releases which are not directed to prospects. However, when the franchisor uses such public information in promotional material directed to prospects it will then fall under the definition of a financial performance representation. The Commission expects that the FTC staff will address the specific scope of general media financial performance representations in subsequent compliance guides.<sup>37</sup>

## 2. Requirements

The New FTC Rule requires that if you make a financial performance representation you must begin by stating the following:

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial

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<sup>35</sup> 16 CFR 436.1(e)

<sup>36</sup> New FTC Rule Statement of Basis and Purpose

<sup>37</sup> New FTC Rule Statement of Basis and Purpose

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 in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.<sup>38</sup>

The New FTC Rule also mandates specific additional language if you do not make a financial performance representation warning prospects not to rely on unauthorized representations and to report any such representations to the company, the FTC and the relevant state agency. The inclusion of the preamble will serve to undercut some franchisor's claims to prospects that the FTC prohibits them making financial performance representations. Prospects could also shop for a system that does make financial performance representations. In addition, the preamble puts the prospect on notice not to rely on claims made outside of the disclosure document.

If a franchisor makes a financial performance representation to prospective franchisees, it must have a reasonable basis and written substantiation for the representation at the time the representation is made and must state the representation in the Item 19 disclosure.

The franchisor must also disclose the following:

(i) Whether the representation is an historic financial performance representation about the franchise system's existing outlets, or a subset of those outlets, or is a forecast of the prospective franchisee's future financial performance.

(ii) If the representation relates to past performance of the franchise system's existing outlets, the material bases for the representation, including:

(A) Whether the representation relates to the performance of all of the franchise system's existing outlets or only to a subset of outlets that share a particular set of characteristics (for example, geographic location, type of location (such as free standing vs. shopping center), degree of competition, length of time the outlets have operated, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated).

(B) The dates when the reported level of financial performance was achieved.

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<sup>38</sup> 16 CFR 436.5(s)

(C) The total number of outlets that existed in the relevant period and, if different, the number of outlets that had the described characteristics.

(D) The number of outlets with the described characteristics whose actual financial performance data were used in arriving at the representation.

(E) Of those outlets whose data were used in arriving at the representation, the number and percent that actually attained or surpassed the stated results.

(F) Characteristics of the included outlets, such as those characteristics noted in paragraph (3)(ii)(A) [Section (ii)(A) above] of this section, that may differ materially from those of the outlet that may be offered to a prospective franchisee.

(iii) If the representation is a forecast of future financial performance, state the material bases and assumptions on which the projection is based. The material assumptions underlying a forecast include significant factors upon which a franchisee's future results are expected to depend. These factors include, for example, economic or market conditions that are basic to a franchisee's operation, and encompass matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses.

(iv) A clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation.

(v) A statement that written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.

### 3. Existing Outlet for Sale

If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with this section, provided the information is given only to potential purchasers of that outlet.<sup>39</sup>

### 4. Supplemental Financial Performance Representations

If a franchisor furnishes financial performance information in compliance with the New FTC Rule, the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. The supplemental representation must:

- (i) Be in writing.

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<sup>39</sup> 16 CFR 436.5(s)(4)

(ii) Explain the departure from the financial performance representation in the disclosure document.

(iii) Be prepared in accordance with the requirements of the New FTC Rule above; and

(iv) Be furnished to the prospective franchisee.<sup>40</sup>

#### 5. Differences from the Original FTC Rule

The New FTC Rule more closely resembles the UFOC Guidelines for Item 19, although with some significant differences discussed below. Accordingly, it differs greatly from the Original FTC Rule. Specifically, the New FTC Rule Statement of Basis and Purpose identifies these differences as:

(h) It eliminates the requirement that franchisor's who decide to make financial performance representations provide prospective franchisees with a separate financial performance representation document;

(ii) It eliminates the requirement that all financial performance claims be geographically relevant to the franchise offered for sale;

(iii) It eliminates the requirement that any historical financial performance claims must be based upon GAAP;

(iv) It permits franchisors, under specific circumstances, to disclose, apart from the disclosure document, the actual operating results of a specific unit being offered for sale; and

(v) It permits franchisors to furnish supplemental performance information directed at a particular location or circumstance.

#### 6. Differences from the UFOC Guidelines

While the New FTC Rule as it pertains to financial performance representations more closely resembles the format and requirements set forth in the UFOC Guidelines, including identifying an earnings claim as Item 19 in the disclosure document, it does contain some significant differences. Differences which make it even easier, and more attractive, for franchisors to make an earnings claim.

The addition of the required preamble is perhaps the most striking difference with the UFOC Guidelines, but more significantly, the New FTC Rule loosens the disclosure requirements relating to making earnings claims based on subsets of franchisor-owned or franchised outlets. For example, the New FTC Rule expressly permits an earnings claim based on all of the system's existing outlets or only to a subset of outlets that share a

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<sup>40</sup> 16 CFR 436.5(s)(5)

particular set of characteristics and limits disclosure of outlets which exceeded the stated result to only those outlets which were used in arriving at the representation. Thus, for a financial performance representation which set forth average gross sales for a specific subset of franchisees, the franchisor would only have to set forth the number of franchisees in that subset which exceeded the average and not the percentage of the system as a whole.

In the New FTC Rule's Statement of Basis and Purpose, the Commission supports this change with the following example: a franchisor may have statistics showing that 9 out of 10 franchised stores in Seattle average \$100,000 net profit a year.

Yet the UFOC Guidelines prevent the franchisor from disclosing truthful information about the universe the franchisor has measured – the 10 franchised outlets in Seattle. Rather, the franchisor would be forced instead to state 9 out of the entire number of all franchises nationwide (e.g. 9 out of 1,000) have earned the \$100,000 claimed. This approach can mislead a prospective franchisee because it suggests that the franchisor has measured the financial performance of all franchisees, when that may not be true. It also may deflate franchisees' actual performance records. More important, a franchisor may decline to disclose performance information if, in order to do so, it must first incur the expense of conducting a system-wide franchisee performance analysis.<sup>41</sup>

However, a franchisor still must have a reasonable basis and must disclose: (1) the nature of the universe of outlets; (2) the total number of outlets in the universe measured; (3) the number of outlets from the universe that was actually measured; and (4) any characteristics of the measured outlets that may differ materially from the outlet offered to the prospective franchisee (e.g., location, years in operation, franchisor-owned or franchisee-owned, and likely competition).<sup>42</sup> Prospects can then assess for themselves what weight to give the financial performance representation.

## 7. Additional Prohibitions

The New FTC Rule also contains additional prohibitions, which relate to the dissemination of financial performance representations. Specifically, Part 436.9 states that it is an unfair and deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act to:

Disseminate any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the

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<sup>41</sup> New FTC Rule Statement of Basis and Purpose

<sup>42</sup> 16 CFR 436.5(s)(3)(ii); New FTC Rule Statement of Basis and Purpose

representation at the time the representation is made, and the representation is included in Item 19 (New FTC Rule Part 436.5(s)) of the franchisor's disclosure document. In conjunction with any such financial performance representation, the franchise seller shall also:

1. Disclose the information required by [New FTC Rule Part 436.5(s)(3)(ii)(B)(E)] if the representation relates to the past performance of the franchisor's outlets.
2. Include a clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation.<sup>43</sup>

In addition, it is a violation of Section 5 of the Federal Trade Commission Act to "fail to make available to prospective franchisees, and to the Commission upon reasonable request, written substantiation for any financial performance representations made in Item 19 [New FTC Rule Part 436.5(s)]."<sup>44</sup>

## **ITEM 20** **OUTLETS & FRANCHISEE INFORMATION**

The New FTC Rule retains the Original Rule's requirement that franchisor's disclose the number of franchised and franchisor-owned outlets; the names, business addresses, and business telephone numbers of current franchised outlets, and statistical information on franchise turn-over rates, specifically the number of franchisees voluntarily and involuntarily terminated, not renewed and reacquired by the franchisor.<sup>45</sup> The New FTC Rule is more closely aligned with the UFOC guidelines by requiring franchisors to disclose the names, business addresses and business telephone numbers of at least 100 current franchised outlets.<sup>46</sup> The Original Rule only required the disclosure of at least 10 franchised outlets. The New FTC Rule also requires the disclosure of contact information for former franchisees. The New FTC Rule requires the statistical information to be presented in a tabular format, which is more user-friendly than the Original Rule.

The New FTC Rule eliminates the double-counting issue that is found in the UFOC Guidelines. The New FTC Rule also limits the disclosure of personal contact information of former franchisees. The UFOC Guidelines require the disclosure of the

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<sup>43</sup> 16 CFR 436.9(c)

<sup>44</sup> 16 CFR 436.9(d)

<sup>45</sup> 16 CFR 436.1 (a)(16)

<sup>46</sup> UFOC Guidelines, Item 20B

names, home addresses and telephone numbers of each franchisee that left the system within the last fiscal year.<sup>47</sup> The New FTC Rule requires the franchisor to disclose an outlet's prior franchisee-owner when it resells an outlet it acquired during the last five fiscal years. The New FTC Rule changes the confidentiality clause in the information the franchisor can restrict franchisees from disclosing with prospective franchisees. Finally, the New FTC Rule requires the disclosure of trademark-specific franchisee associations.

### **Double-counting**

The New FTC Rule Item 20 requires disclosure of information about franchisees who have recently left the franchise system, as well as changes in ownership franchised outlets, as required under the UFOC Guidelines. However, the complaint under UFOC Guideline Item 20 was the often results in franchisors "double-counting" changes in franchised outlet ownership, resulting in inflated turnover rates.

The UFOC Guidelines Item 20 requires franchisors to report changes in franchised outlets ownership according to five enumerated categories: (1) transferred; (2) canceled or terminated; (3) not renewed; (4) reacquired by the franchisor, or (5) reasonably known to have "ceased to do business." However, UFOC Guidelines do not define these terms for each category required, leading to confusion.<sup>48</sup> Furthermore, the UFOC Guidelines implicitly require disclosure of each series of events associated with a single outlet ownership change.<sup>49</sup>

The New FTC Rule avoids the double-counting affect caused under the UFOC Guidelines. The category term for "termination" is defined as "the franchisor's termination of a franchise agreement prior to the end of it term and without paying consideration the franchisee (whether by payment or forgiveness or assumption of debt)." "Non-renewal" is "when the franchise agreement for a franchised outlet is not renewed at the end of it term." "Reacquisition" means "the franchisor's acquisition of an outlet for consideration (whether by payment or forgiveness or assumption of debt) of a franchised outlet during its term." "Transfer" means "the acquisition of a controlling interest in a franchised outlet during its term by a person other than the franchisor or an affiliate."<sup>50</sup>

Accordingly, Item 20 of the New FTC Rule contains five tables. Table No.1 indicates the status of a franchisor's system. It shows the number of franchised and company-owned outlets at the beginning and end of each of the last three fiscal years, and the total net change.

Table No.2 shows transfers, treating them separately from terminations and non-renewals. Table No.2 indicates the number of franchise transfers in each state over the last three fiscal years.

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<sup>47</sup> UFOC Guidelines, Item 20E

<sup>48</sup> UFOC Guidelines, Item 20D

<sup>49</sup> Franchise NPR, 64 FR at 57312; Staff Report, at 173-77

<sup>50</sup> Staff Report, at 48-53

Table No.3 tracks the turnover rate of franchised outlets. Franchisors must report, by state and for each three fiscal years, the 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 the end of the year.

Table No.4 tracks the turnover at company-owned outlets. Franchisors must disclose, for each of the last three fiscal years, the number of their outlets at the start of the year, new outlets, reacquired outlets, closed outlets, outlets sold to franchisees, and outlets at the end of the year.

Finally, Table No.5 retains the current UFOC projected openings table. This table gives prospective franchisees insight into anticipated growth within the system by acquiring the disclosure of both projected franchised and company-owned openings in the next fiscal year.

### **Identification of former franchisees**

Section 436.5(t)(5) of the New FTC Rule adopts the Franchise NPR proposal that franchisors disclose contact information for franchisees that have exited the franchise system in the most recently completed fiscal year.

The New FTC Rule provision requires franchisors to disclose only the name, city, and state, and current business telephone number, or, if unknown, the last known home telephone number of former franchisees. Additionally, franchisors must state the following language in conjunction with the list of former franchisees: “If you buy this franchise, your contact information may be disclosed in the future to other buyers when you leave the franchise system” in order to give prospective franchisees notice that their contact information may be disclosed even after they leave the franchise system. To allow for greater flexibility, footnote 10 to the New FTC Rule provides that franchisors may substitute alternative contact information at the request of the former franchisee, such as a home address, post office address, or a personal or business email address.

### **Identification of former franchisee-owners of a specific outlet being resold**

Section 436.5(t)(6) of the New FTC Rule extends the original Rule and UFOC Guidelines Item 20 by addressing turnover at a specific outlet. When a franchisor resells an outlet under its control that was previously owned by a franchisee, Item 20 requires the franchisor to disclose contact information for each previous owner of that outlet, the time of period when the previous owner controlled the outlet; the reason for each previous ownership change; and the time period(s) when the franchisor retained control of the outlet. AS explained below, this provision is designed to prevent fraud in the resale of a specific franchised outlet, by giving prospective purchasers of that outlet sources of information with hands-on experience operating the outlet.

## **Confidentiality clauses**

Section 436.5(t)(7) addresses franchisors' uses of confidentiality clauses, as proposed in the Franchise NPR. This is a new provision that is not in the original Rule or UFOC Guidelines. If, during the last three fiscal years, franchisees signed a confidentiality clause in a franchise agreement, settlement, or in any other contract with the franchisor, the franchisor must insert Item 20 disclosure the following prescribed statement: "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. "In addition, a franchisor may, at its option, also disclose the number and percentage of current and former franchisees who signed confidentiality agreements, as well as the circumstances under which such clauses were signed.

The commission believes that the New FTC Rule's confidentiality clause disclosure requirement strikes the appropriate balance between informing prospective franchisees that franchisees in the system may not be able to share information with them, and minimizing compliance burdens.

Other than the required statement explaining the nature of confidentiality clauses to prospects who may be unfamiliar with their use, any other disclosure-such as number and percentage or the reasons for the clauses- are entirely voluntary.

Further, the confidentiality clauses disclosure does not reach confidentiality clauses addressing specific contract negotiation terms and conditions.

## **Franchisee Association**

One important difference between the original Rule and UFOC Guidelines, on the one hand, and the New FTC Rule, on the other, is the new requirement that franchisors disclose trademark-specific franchisee associations. The obligation to disclose such associations differs depending upon whether the association is sponsored or endorsed by the franchisor or is an independent association. Section 436.5(t)(8) provides that identifying information – name, address, telephone number, email address and Web address, to the extent known – must be included for each association "created, sponsored, or endorsed by the franchisor." For independent association, the same identifying information must be disclosed only if the independent association:

Is incorporated or otherwise organized under state law and asks the franchisor to be included in the franchisor's disclosure document during the next fiscal year. Such organizations must renew their request on an annual basis by submitting a request no later than 60 days after the close of the franchisor's fiscal year.

The UFOC Guidelines currently require disclosure of the existence of purchasing cooperatives known to the franchisor, but this is not adequate disclosure of a fact of

growing importance to franchisees, which is the existence, or non-existence, of an autonomous franchisee association representing franchisees in that particular franchise organization.

Finally, a franchisee association disclosure is particularly important given that the New FTC Rule does not mandate financial performance disclosures.

At the same time, the disclosure of franchisee association is very narrowly tailored to address franchisors' concerns about the disclosure of the independent franchisee association. Specifically, Item 20 of the New FTC Rule provides that a franchisor must list in its disclosure document independent trademark-specific associations only to the extent such associations make their existence known to the franchisor on an annual basis.

Specifically, Item 20 of the New FTC Rule: (1) broadens the types of associations that qualify for inclusion as a trademark-specific franchisee association; (2) requires franchisee associations to request inclusion in the franchisor's disclosure document within 60 days of the end of the franchisor's fiscal year end; and (3) permits franchisors to add qualifying language alerting prospective franchisees that the associations listed in its disclosure document are independent associations.

Item 20 of the New FTC Rule requires franchisors to disclose only those independent franchisees associations that are incorporated or otherwise organized under state law.

Accordingly, any organized independent association – whether it is incorporated, a partnership, limited liability, or trust, among other forms of association - qualifies for inclusion under Item 20.

Item 20 of the New FTC Rule makes explicit that an independent franchisees association's requests for inclusion in a disclosure document must be renewed annually by submitting a request for inclusion no later than 60 days after the close of the franchisor's fiscal year.

Item 20 of the New FTC Rule permits to include a limited disclaimer, if they wish. Specifically, Item 20 provides that a franchisor can add to the independent franchisees association disclosure the following statement: The following independent franchisees associations have asked to be included in this disclosure document. We believe this statement makes clear that the franchisor is not necessarily endorsing or supporting the associations listed.

The Commission recognized that Item 20 might result in the disclosure of independent franchisees associations that are not necessarily representative of franchisees as a whole. However, we believe there is a value in enabling prospective franchisees to speak with an association representing similar interest, even if not representative of the entire system.

## **ITEM 21** **FINANCIAL STATEMENTS**

Item 21 of the New FTC Rule generally maintains the Original FTC Rule requirement that franchisors disclose three years of audited financial statements prepared according to generally accepted accounting principals (“GAAP”).<sup>51</sup> The New FTC Rule also incorporates the UFOC Guidelines’ requirement that financial statements be in a tabular format that compares data of at least two fiscal years. The UFOC Guidelines’ requirement allows franchisees to assess the financial data, rather than just a snapshot for a single year.

Although the New FTC Rule incorporates part of the UFOC Guidelines, it also expands on the UFOC Guidelines. The New FTC Rule recognizes the need for the federal government oversight committee to make changes in the reporting requirement, therefore the New FTC Rule provides for franchisors to use GAAP, as revised by any future government mandated accounting principals. The New FTC Rule also permits accounting standards recognized by the Securities and Exchange Commission (the “SEC”). The New FTC Rule also requires the disclosure of a parent’s financial information, specifically if the parent will have any post-sale obligations or guarantees of franchisor’s obligations. Finally the New FTC Rule allows franchisors to utilize phase-in audited financial statements over three years.

### **Foreign Franchisors**

The financial data must be in a format that is useful for the American prospective franchisee in making an informed investment decision. Therefore, foreign franchisors must use United States GAAP or reconcile the financial statements to U.S. GAAP.<sup>52</sup> The SEC allows foreign companies to prepare financial statements using alternative accounting procedures in limited circumstances. The SEC requires foreign companies using alternative financial statements be prepared according to a comprehensive body of accounting principles and disclose the specific comprehensive body of accounting principles used in the preparation of the financial statements, explaining the differences between such principles and U.S. GAAP. The foreign companies must also reconcile its financial statements with U.S. GAAP. This can be accomplished through additional notes to reconcile figures for net income and total shareholders’ equity for the disclosed periods. The alternative statements must also provide the required disclosures under U.S. GAAP and by the SEC.

### **Parents and Subfranchisors**

The New FTC Rule requires the franchisor to disclose a parent’s financial statements in limited circumstances. A franchisor must disclose the parent’s financial statements only when: 1) the parent assumes the performance of post-sale obligations of the franchisor; or 2) the parent guarantees the obligations of the franchisor. Additionally,

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<sup>51</sup> 16 CFR 436.1(a)(20)

<sup>52</sup> Staff Report, at 201

the New FTC Rule requires the disclosure of any subfranchisor. The term “subfranchisor” is limited under the New FTC Rule to circumstance in which the subfranchisor assumes the duties of the franchisor in selling and franchisor’s post-sale obligations. The term will not include subfranchisors that act like brokers and do not have any post-sale obligations to franchisees.

### **Phase-in Audits**

The New FTC Rule allows start-up franchise systems, which is to be narrowly construed, to phase-in audited financial statements within three years as the Original Rule permitted. The UFOC Guidelines have no similar provision. Start-ups under the New FTC Rule only include those companies that are newly formed businesses just entering the franchise market. The Original Rule allowed franchisors to provide a balance sheet for the first full fiscal year following the date on which the franchisor must comply with the Rule.<sup>53</sup> Section 436.5(u)(2) of the New FTC Rule the term “full” is replaced with “first partial or full fiscal year.”<sup>54</sup> Under the New FTC Rule, the franchisor’s first fiscal year will end consistent with its accounting method. Therefore, the FTC will only look to the close of the franchisor’s first fiscal year after selling franchises. The phase-in audited financial statements are still required to be prepared according to U.S. GAAP, and merely addresses the requirement that financial statements be audited according to United States generally accepted audited standards.<sup>55</sup>

### **ITEM 22** **CONTRACTS**

Item 22 is consistent with the UFOC Guidelines requiring franchisors to attach to the disclosure documents a copy of all relevant contracts and agreements, including the franchise agreement, leases, options or purchase agreement.<sup>56</sup> The New FTC Rule only requires the inclusion of those contracts that exist at the time of the sale, and do not contracts that may be used in the future, which the New FTC Rule explicitly excluded.

### **ITEM 23** **RECEIPTS**

Finally, Item 23 of the New FTC Rule requires the inclusion of an acknowledgement of receipt in the disclosure document by the franchisor, in which there is no similar requirement under the Original Rule. The New FTC Rule is comparable to the UFOC Guidelines, however the New FTC Rule gives more flexibility to the franchisor and franchisee. The receipt serves as an important purpose to inform the prospective franchisee about the 14-day review period, that certain agreements are attached to the disclosure document, and that they can report any violations. The New

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<sup>53</sup> 16 CFR 436.1(a)(20)(ii)

<sup>54</sup> Franchise NPR, 64 FR at 57315

<sup>55</sup> 16 CFR 436.1(a)(20)(i)

<sup>56</sup> UFOC Guidelines Item 22

FTC Rule also changed the recordkeeping requirement under Section 436.6 to maintain a copy of signed receipts for at least three years.

The New FTC Rule allows more flexibility for both franchisors and franchisees in the manner of demonstrating receipt. The UFOC Guidelines only permitted acknowledgment of receipt through a handwritten signature, the New FTC Rule allows the parties to utilize electronic signatures to acknowledge receipt. New FTC Rule defines signature to include electronic signatures, passwords, security codes and other devices that enable a franchisee to easily acknowledge receipt, confirm identity and submit the acknowledgement to the franchisor.

The New FTC Rule retains the 14-day review period in which franchisor must provide to prospective franchisee before signing the franchise agreement. However, the New FTC Rule eliminates any additional review period where the changes to the agreement are negotiated. Alternatively, the New FTC Rule requires franchisors to wait an additional 7 days before franchisees can sign if franchisor makes a unilateral change.

The New FTC Rule requires the disclosure of the sellers in Item 23, including brokers. The New FTC Rule also notes that this requirement is to be read narrowly and only requires the disclosure of contact information for any seller he/she will be dealing with.

## **PROHIBITIONS GENERALLY**

The New FTC Rule added five new prohibitions while amending the original four.<sup>57</sup>

### **1. Requirements**

The New FTC Rule prohibits nine acts or practices that violate Section 5 of the FTC Act. The Original FTC Rule contained four of them, namely, prohibitions against: (1) making statements that contradict the franchisor's disclosures;<sup>58</sup> (2) making financial performance representations without a reasonable basis and without written substantiation for the representation at the time the representation is made;<sup>59</sup> (3) failing to make available written substantiation for any financial performance representations;<sup>60</sup> and (4) failing to make promised refunds.<sup>61</sup>

The New FTC Rule adds two new prohibitions concerning the furnishing of disclosures. Specifically, it prohibits franchise sellers from failing to furnish a copy of the basic disclosure documents to prospective franchisees early in the sales process, upon reasonable request.<sup>62</sup> Moreover, it prohibits franchise sellers from failing to furnish a

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<sup>57</sup> Federal Register, Vol. 72, No. 61, 15530, Rules and Regulations (March 30, 2007).

<sup>58</sup> 16 CFR 436.1(f).

<sup>59</sup> 16 CFR 436.1(b)(2),(c)(2).

<sup>60</sup> 16 CFR 436.1(b)(2),(c)(2).

<sup>61</sup> 16 CFR 436.1(h).

<sup>62</sup> 16 CFR 436.9(e).

prospect in the sales process who has already received the basic disclosure document with a copy of any updated disclosure document or quarterly update to an existing disclosure document, upon reasonable request, before the prospective franchisee signs a franchise agreement.<sup>63</sup>

The New FTC Rule also added two anti-fraud prohibitions designed to preserve the integrity of the disclosure document and franchise agreement. First, it prohibits franchise sellers from materially altering the terms and conditions of any franchise agreement presented to a prospective franchisee for signing, unless the seller informs the prospective franchisee of the changes seven days before execution of the agreement.<sup>64</sup> Second, it prohibits franchise sellers from disclaiming or requiring a franchisee to waive reliance on any representation made in a disclosure document or its exhibits or attachments.<sup>65</sup>

Finally, the New FTC Rule adds a new anti-shill prohibition designed to prevent the use of paid testimonials or shill references. Specifically, it prohibits franchise sellers from misrepresenting that any person has purchased a similar franchise or operated a similar franchise from the franchisor, or that any person can provide an independent and reliable report about the franchise or the experiences of any current or former franchisees.<sup>66</sup>

#### **Section 436.9(a): Inconsistent Statements**

This section of the New FTC Rule retains the Original FTC Rule's prohibition against making statements that contradict the information disclosed in the disclosure document. Such prohibited contradictory statements include those made orally, visually, or in writing. Because the information in the disclosure document must be complete and accurate, any statements contradicting that information would be false or likely to mislead prospective franchisees.

#### **Section 436.9(b): Shills**

This section prohibits the franchise sellers from misrepresenting that any person has actually purchased operated one of the franchisor's franchises or that any person can give an independent and reliable report about the experience of any current or former franchisee. Because information provided by shills is inherently false, it is likely to mislead prospective franchisees. The FTC's law enforcement experience shows that shills are often the glue that holds a scam together by allaying consumers' concerns about the investment risks.

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<sup>63</sup> 16 CFR 436.9(f).

<sup>64</sup> 16 CFR 436.9(g).

<sup>65</sup> 16 CFR 436.9(h).

<sup>66</sup> 16 CFR 436.9(b).

### **Section 436.9(c): Financial Performance Representations**

This section retains the Original FTC Rule’s prohibition on the making of financial performance representations, unless the franchisor has a reasonable basis and written substantiation for the representations at the time the representation is made. However, the New FTC Rule has been amended to permit the franchisor to make financial representations in Item 19 of the disclosure document. This achieves greater uniformity with the UFOC Guidelines, by eliminating the Original FTC Rule’s requirement that a franchisor making financial performance claims furnish prospects with a separate earnings disclosure document.

### **Section 436.9(d): Availability of Financial Performance Substantiation**

This section also retains the Original FTC Rule’s prohibition against failing to make available to prospective franchisees and to the FTC, upon reasonable request, written substantiation for any financial performance representation made in Item 19. This prohibition ensures that prospective franchisees and the FTC can review and verify the data underlying any performance representation, while relieving franchisors of the burden of having to present what could be voluminous data in the disclosure document itself.

### **Section 436.9(e): Earlier Disclosure Upon Request**

This section prohibits a franchise seller from failing to furnish a copy of the franchisor’s disclosure document to a prospective franchisee earlier than required, upon request. Accordingly, any prospective franchisee in the sales process can obtain a copy of the franchisor’s disclosure document before the standard 14-day period for making disclosures. Because prospects may incur a variety of costs in determining whether to consider a particular franchise offering, a franchisor’s withholding of its disclosure document can result in economic injury. The FTC is convinced that this prohibition is also necessary in light of the elimination of the Original FTC Rule’s mandatory face-to-face disclosure trigger. Given the explosion of alternative media since the Original FTC Rule was promulgated in the 1970s, the face-to-face disclosure trigger has become obsolete.

### **Section 436.9(f): Furnishing Updated Disclosures**

This section prohibits a franchisor from failing to furnish a prospective franchisee that has received a basic disclosure document with updated disclosures, upon the prospect’s reasonable request. Specifically, it prohibits the franchisor from failing to furnish “the franchisor’s most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisee signs a franchise agreement.”<sup>67</sup> At the same time, this does not impose a continuous updating requirement on franchisors. Rather, it strikes the appropriate balance, preventing deception by enabling a prospective franchisee to gain access to the most current updated disclosures

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<sup>67</sup> 16 CFR 436.9(f).

prepared by the franchisor, while imposing no new affirmative disclosure obligations on the franchisor.

### **Section 436.9(g): Unilateral**

This prohibition bars franchise sellers from substituting provisions or pages in the agreement without first bringing such changes to the prospective franchisee's attention at least seven days before execution of the agreement. The New FTC Rule eliminated the Original FTC Rule's requirement that franchisors in every case afford a prospective franchisee five business days to review the completed franchise agreement. The FTC concluded that the review period is unnecessary, provided that the franchise seller does not make any unilateral modifications to the basic form of the franchise agreement previously furnished to the prospective franchisee at the time of furnishing its disclosure document.

### **Section 436.9(h): Disclaimers and Waivers**

This section prohibits franchise sellers from disclaiming or requiring "a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments."<sup>68</sup> This prohibition is intended to prevent fraud by preserving the completeness and accuracy of information contained in the disclosure documents. The scope of this section does not reach statements made in a franchisor's advertising materials. Moreover, this provision does not inhibit parties' ability to contract. Specifically, it states that it: "is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sales negotiations."<sup>69</sup>

### **Section 436.9(i): Refunds**

This section prohibits franchisors from failing to make refunds as promised in their disclosure document or in a franchise or other agreement. The failure to honor refund promises is an unfair practice in violation of Section 5. This section retains, but slightly revises the Original FTC Rule's prohibition against failing to make promised refunds. The Original FTC Rule prohibited franchisors and brokers from failing "to return any funds or deposits in accordance with any conditions disclosed pursuant to paragraph (a)(7)."<sup>70</sup> This provision was limited to instances where the franchisor or broker makes an express refund promise in the disclosure document itself. It is possible, however, that a franchise seller may not make any specific promise in the disclosure document itself, but may do so either in the franchise agreement, or in a separate contract or letter of understanding. The harm resulting from the failure to honor a promised refund is the same, regardless of where that promise is written. As a result, the New FTC Rule makes clear that the failure to honor any written refund promise will constitute a violation.

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<sup>68</sup> 16 CFR 436.9(h).

<sup>69</sup> *Id.*

<sup>70</sup> 16 CFR 436.1(h).