

## A PROPOSED FACELIFT TO THE FTC FRANCHISE RULE

BY: LARRY WARD

Almost ten years after commencing its regulatory review of the Franchise Rule (the “Rule”), the Federal Trade Commission (“FTC”) released its *Staff Report Regarding Disclosure Requirements and Prohibitions Concerning Franchising* (the “Report”) on August 25, 2004. After nearly a decade of soliciting comments on the Rule, receiving and reviewing countless written comments on the Rule, and holding six public workshops to address the Rule in a round-table fashion, the FTC has released the Report and has allowed until November 12, 2004 for the public to review and comment on the 400-page Report.

Ultimately, the Report proposes that the FTC should retain the Rule as it continues to serve a useful purpose. The Report essentially makes three broad recommendations to the FTC:

- **Narrow the Rule:** The Report suggests that the Rule be narrowed to focus exclusively on franchises.
- **Adopt Changes to the Disclosures:** The Report suggests that the Rule be revised in such a way that its requirements regarding disclosures be more consistent with NASAA’s UFOC disclosure guidelines.
- **Regulations Affecting the Franchise Relationship are Unnecessary:** The Report suggests that further regulations affecting post-sales franchisor-franchisee relationships are unnecessary.

### Narrowing the Rule:

One of the major recommendations of the Report was that the FTC should limit the scope of the Rule. Specifically, the Report recommended that the Rule should be amended to focus solely on business-format franchises by revising the definition of “franchise,” and thus eliminating business opportunities from the scope of the Rule. The Report stated that the principal concern regarding business opportunities is outright fraud. Under the new definition of “franchise,” the franchisor would have to offer significant assistance “extending beyond the start of the business operation.” Thus, by revising the definition of “franchise,” business opportunities would no longer be subject to the regulations under the Rule; accordingly, the Report recommends that the FTC draft a separate business opportunity rule that calls for disclosures specific to business opportunities. This recommendation benefits franchisors significantly as business opportunities have traditionally generated a greater number of complaints and as the disclosures required by the FTC can be more narrowly tailored to business format franchising.

## Disclosure Changes:

The thrust of the Report is in regards to the Staff's recommendations regarding disclosures. Ultimately, the Report recommends expanding the current FTC Rule to add disclosure requirements that are strikingly consistent with the UFOC guidelines used in the various franchise registration states. The ultimate goal behind this is to improve the effectiveness of the FTC disclosure document to ensure that prospective franchisees are best educated about a particular franchise and to ensure that franchisors can utilize the disclosure document in a way that is most effective as a sales marketing tool.

The major highlights regarding the new disclosure requirements are outlined below:

- *Item 1: The Franchisor and Any Parent, Predecessors, and Affiliates* – Item 1 would be expanded to require franchisors to disclose information about their predecessors for the preceding ten (10) years. The Staff's rationale behind this disclosure is to prevent franchisors from hiding prior misconduct and avoiding disclosure obligations simply by assuming a new corporate identity.
- *Item 2: Business Experience* – Item 2 would be expanded to require franchisors to disclose information regarding *de facto* officers (i.e. those individuals that do not have a corporate officer title, but that indeed function as corporate officers) and would need to disclose the business experience of a parent's managers.
- *Item 3: Litigation* – Item 3 would require the same disclosures as the UFOC guidelines; however, franchisors would be required to disclose actions involving predecessors, as well as routine litigations impacting the franchisor's financial condition. Furthermore, the Rule would be expanded to require franchisors to disclose material franchisor-initiated litigation against franchisees involving the franchise relationship. This expansion would be different from the UFOC guidelines and from the current FTC Rule.
- *Item 4: Bankruptcy* – Item 4 would require disclosures regarding bankruptcies for the previous ten (10) years.
- *Item 10: Financing* – Item 10 would expand the current FTC Rule to require a franchisor to disclose all material terms and conditions of any financing agreements. Franchisors would be required to disclose any interest on the financing in terms of annual percentage rate and would require more disclosure about what the financing covers, waivers of defenses, and the franchisor's practice or intent to sell or assign the obligation to a third party.

- *Item 19: Financial Performance Representations* – Item 19 is perhaps the most important anti-fraud disclosure. Currently, the FTC Rule describes performance information as “any oral, written, or visual representation to a prospective franchisee which states a specific level of potential sales, income, gross, or net profit for the prospective franchisee, or which states other figures which suggest a specific level.” The Staff proposed a more explicit definition of the term “financial performance representation” as “any oral, written, or visual representation to a prospective franchisee, including a representation disseminated in the general media and Internet, that states or suggests a specific level or range of potential or actual sales, income, gross profits, or net profits. A chart, table, or mathematical calculation that demonstrates possible results based upon a combination of variables is a financial performance representation.” In addition, the Staff recommended eliminating references to expense information from the definition of the term. To avoid any confusion, the Staff recommended that it be made clear in the compliance guides that the Rule’s cost-disclosures in Items 5-7 alone do not constitute the making of a financial performance representation.

Under the proposed Rule, it would still be voluntary whether a franchisor offers financial performance representations because the Staff recognized that false or misleading financial performance representations represent the most common franchise law enforcement actions.

The proposed changes to the Rule would make it more consistent with documents prepared in the UFOC format. In doing so, the Rule would not require franchisors to provide prospective franchisees with a separate earnings claims document; instead, allowing performance claims and evidence thereof in the text of the disclosure document itself.

Moreover, the Rule would eliminate the current requirement that all financial performance claims be geographically relevant to the franchise offered for sale. Under certain circumstances, the franchisor would be able to disclose the actual operating results for the specific unit for sale.

In addition, revisions to the current Rule’s requirement regarding performance representations of subgroups of franchisees have been proposed. Under the current Rule and the UFOC guidelines, franchisors must compare the number of franchisees performing at a certain claimed level against all franchisees in the system, not just some set of franchisees that have performed out of the ordinary. The FTC determined that this requirement was misleading, as many franchisors do not analyze performance data for all of their franchisees.

Thus, the Commission proposed allowing representations about a certain subgroup of franchisees provided that the franchisor meets four

requirements: (1) define the universe of franchisees measured; (2) provide the number of total franchisees in the universe measured; (3) provide the number of total franchisees from that universe that were actually measured; and (4) provide characteristics of the measured franchisees that differ materially from the proposed offer.

- *Item 20: Outlets and Franchisee Information* – Item 20 would expand the scope of the current FTC Rule to mirror the UFOC guidelines; however, the proposed Rule would differ from the UFOC guidelines in two respects. First, the proposed Rule would eliminate a double-counting problem by addressing the core source of the problem – imprecise reporting categories. To achieve this result, mutually exclusive reporting categories would be added to denote “termination,” “reacquisition,” and “transfer.” In addition, double-counting of turnover information would be reduced by adopting a “first-in-time” approach. Second, the Rule would require disclosure about a franchisor’s requirement by which franchisees are bound by a “confidentiality” or “gag” clause, which effectively restrict franchisees from discussing their experiences with prospective franchisees.

#### Franchise Relationships:

One of the strongest criticisms received by the Staff during the comment period came from franchisees and their advocates regarding the limitation of the scope of the Rule. The current Rule regulates pre-sale disclosures only and does not regulate post-sales abusive franchise relationships. Franchisees urged the FTC to adopt changes to the Rule prohibiting post-term covenants not to compete, prohibiting encroachments, and restricting regulations regarding approved products and services. The Staff concluded, however, that the extensive pre-sale disclosures protect prospective franchisees from fraudulent and deceptive franchise sales practices and in turn protect prospective franchisees from abusive franchise relationships. Ultimately, the Staff stated that the FTC lacks the statutory ability to broaden the Rule to address post-sales franchise relationship issues as franchise relationships are private contractual matters that are regulated by the individual states. The Staff noted that most injuries to franchisees can be prevented as franchise purchases are strictly voluntary.

In addition to the recommendations highlighted above, the FTC also recommended the following: the Rule should not apply to international franchise transactions; the first personal meeting rule should be eliminated so that disclosure documents must be delivered no later than fourteen (14) days before contract signing or payment of fees; electronic disclosures should be allowed subject to certain regulations; and exemptions should be added for large/sophisticated franchisees, franchisees that are part of the franchisor’s ownership/management, and franchises that involve significant investments.

In all, the Staff has recommended a Rule that will ensure ease of compliance as it is consistent with the requirements of the UFOC guidelines. It is anticipated that the FTC will adopt that changes recommended in the Report and that each state will likely amend state laws to be consistent with Rule changes.