

FTC Rule Change: The Question Of When

BY LANE FISHER

For those of you who have been living under a rock for the past 10 years, I have a newsflash: Since 1995, The Federal Trade Commission has been involved in a rule-making process to amend the FTC Rule (the “Rule”) to change certain disclosure requirements and to recognize certain changes to the franchise business sales model and use of technology in the franchise sales process. What we know is the likely substance changes; what we don’t know is when they’ll be implemented.

There has been almost as much written about when the Rule changes will become effective, as about the Rule itself. The smart commentators are exercising restraint in making even the next estimate of when the Rule changes will become effective. If you are dying for the Rule change, blame the spammers, telemarketers, and junk faxers for consuming all your regulatory resources.

Many of you remember, if not the entire process, many pieces along the way. 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 released the Report Regarding Disclosure Requirements and Prohibitions Concerning Franchising last August and solicited public comments through November, leaving only the finalizing of the Rule, and drafting the Statement of Basis and Purpose to be completed and submitted to the Commission for review and approval. These final 2 steps have been completed, and the entire package is awaiting action by the Commission. There are no time limits within which the Commission has the authority and discretion to devote resources to the most compelling matters.

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 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.

In addition, the Rule joins the 21st Century by permitting the use of electronic disclosure and eliminates disclosure for brokers (including their litigation and bankruptcy history), resolving a sea of uncertainty precipitated by the modern use of multi-broker franchise lead referral methods, which has suffered from overdisclosure in the past few years.

Narrowing the Rule:

The Report recommends that the Rule be amended to focus solely on business-format franchises by the definition of “franchise,” and thus eliminating coverage of 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.” This recommendation benefits franchisors significantly as business opportunities have traditionally generated a greater number of

complaints and the disclosures required by the FTC can be more narrowly tailored to business format franchising.

Disclosure Changes:

Many of the Report's recommendations are intended to update the Rule to be more consistent with the UFOC guidelines used in the various franchise registration states.

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

- **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 and permit like claims to be presented together-such as royalty collection actions. There is no 7- or 10- year carryover; the Rule would require disclosure of pending actions only. Actions involving "the franchise relationship" are defined as those contractual obligations between a franchisor and franchisee directly relating to the operation of the franchised business – like royalties and training obligations. It does not include third party or tort claims. This disclosure is different from the UFOC Guidelines and current Rule. The practical effect of these alternative forms of dispute resolution, which are not disclosable, prior to initiating an enforcement action against a franchisee.
- **Item 4: Bankruptcy** – Item 4 extends the disclosure period to 10 years rather than the existing 7 years to match the UFOC Guidelines and retains the requirement to disclose a parent's bankruptcy.
- **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 the annual percentage rate of any financing 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: Earnings Claim** – The new Rule significantly affects an earnings claim disclosure. Under the new Rule, the name of the disclosure is changed from "earnings claims" to "financial performance representation." The new Rule permits franchisors to provide financial performance information to prospective franchisees for all or a subgroup of company-owned and/or franchised outlets if it discloses the number and percentage of outlets that attained or surpassed the stated results based on the number of outlets in the subset rather than the number of outlets in the entire franchise system, along with any characteristics of the measured subset that differ from the offered unit. The new Rule eliminates the geographic relevance requirement under the Rule. The new Rule also adopts the approach taken under the UFOC format which permits franchisors to provide financial performance information within the body of the main disclosure document, thus eliminating the need to separate earnings claim disclosure document.
- **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 with two respects. First, the proposed Rule would eliminate a

double-counting problem by adopting and using a “first-in-time” approach. Second, the Rule would require a franchisor to identify any franchisees subject to a confidentiality agreement, presumably to advise prospects that certain franchisees have signed contracts restricting their ability to discuss the relationship. Franchisors can express this measure either in terms of the number or percentage of franchisees under a confidentiality order and explain the circumstance surrounding such orders. Franchisors must also disclose any franchisor created franchisee organizations and incorporated independent organizations that request inclusion.

The Report recommends that the existing five-business-day rule within which a franchise must obtain a final version of his proposed franchise agreement with all of the blanks filled in, be changed to five calendar days with a three-day extension for mailing. The proposed Rule eliminates the “first personal meeting” trigger of when you must give disclosure in favor of a 14-day prior-to-sale disclosure requirement.

The information contained in a disclosure document will be required to be updated quarterly, but updates may be sent under a separate cover to franchisees who have already been disclosed. The plain English requirement has been retained and the Rule does not provide a private right to action to franchisees.

New Exemptions

There are also exemptions for large/sophisticated franchisees that are part of the franchisor’s ownership/management, and franchises that involve investments exceeding \$1,000,000. The Report also makes clear that the proposed Rule would not apply to international franchise transactions.

Electronic Disclosure

Electronic delivery of the disclosure document will be permitted without any requirement to deliver a paper copy of a Receipt. Documents may be transmitted by fax, e-mail, and electronic copies (cd-rom or similar medium), or through directions for accessing the document on the Internet. The prospect must also be able to store, download, print or otherwise retain the document for future reference. While, scroll bars, internal links and search options will be permitted, no enhancements, such as video, pop-up menus or similar techniques may be used. Before furnishing a disclosure document, the prospect must be advised of the formats in which the document is available and any computer programs needed to view or obtain the document. Franchisors who offer the document in different formats will be permitted to use a prescribed statement on the cover page of the disclosure document. Prospective franchisees will be permitted to execute a Receipt with an electronic signature and password and may return them by mail, e-mail or facsimile. In addition, franchisee representatives, like lawyers or accountants, will be permitted to receive a disclosure document and sign the Receipt on behalf of the prospect.

During the comment period, franchisee advocates sought to have the scope of the Rule extended to regulate post-sale abusive franchise relationship. 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 Report 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 Report stated that the FTC lacks the statutory ability to broaden the Rule to address post-sale franchise relationship issues, as franchise relationships are private contractual matters that are regulated by the individual states. The Report noted that most injuries to franchisees can be prevented as franchise purchases are strictly voluntary.

The Report has recommended a Rule that will ensure ease of compliance as it is consistent with the new requirements of the UFOC Guidelines. Once the FTC adopts a new Rule, each state will likely amend state laws to be more consistent with Rule changes.

