



FOCUS ON FRANCHISING

ALERT

THE NEW FTC RULE – WHAT TO DO NOW?

These are certainly interesting times. The new Federal Trade Commission Rule on Franchising goes ‘live’ in less than 10 days. Franchisors can choose to fully comply with the new Rule from July 1, 2007, but they can also wait until the Rule becomes mandatory in July 2008. While many franchisors plan to wait a year to comply, some should reconsider since the new FTC Rule has certain benefits that make early compliance advantageous. Key among these benefits are permissive electronic disclosure rules and the ability to provide cost information without triggering earnings claim (now called “financial performance representation”) requirements.¹

As of the date of this Alert, the FTC has yet to issue its Franchise Rule Compliance Guides, not expected until July. There has been little news as to an accord between the FTC and state administrators on how conversion to the new FTC Format will be handled by the states, many of which need to amend their registration and disclosure statutes and revise their regulations to accord with the new FTC Rule. State legislatures will also influence this process, so reaching an accord is no small feat. Despite slow progress on the Compliance Guides, franchisors should be preparing for the upcoming mandatory conversion to the new FTC require-

ments and determining the point at which conversion to the new FTC requirements is advantageous. In preparation for not only the change but also for the decision as to when, we have identified the following two action items for our franchisor clients and friends to focus on today.

1. Electronic Disclosure. Although electronic disclosure will be permitted, it is not enough to simply have a sales assistant commence e-mailing disclosure documents. First, the franchisor must advise the prospective franchisee of the formats in which the disclosure document will be made available as well as prerequisites and conditions for obtaining and reviewing the disclosure document in a particular format. The FTC’s Statement of Basis and Purpose makes clear that this includes, for example, any special computer capabilities or applications necessary to view the file. As the new Rule seems to permit electronic signatures on the Acknowledgements of Receipt, it also appears that this function can be paperless.

Franchisors should consider how they will implement electronic disclosure and have the system tested and ready for use on their commencement date. This must be implemented in compliance with the new

¹ Please keep in mind that franchisors must adopt the new FTC Rule in full or stay with the old. Franchisors cannot start complying with the electronic disclosure rules, disclosure requirements or other advantageous aspects of the new Rule unless they fully convert to the new disclosure document format and all of the other new FTC Rule requirements.

FTC Rule and in a manner that will allow the franchisor to insert the required description of its electronic disclosure program into its disclosure document. Franchisors should ensure any new disclosure system follows advice of counsel and complies with legal recommendations regarding record keeping to provide proof of disclosure in the event of a dispute.

2. Gathering Information. In light of the 12-year-long Rule review, it is surprising how little additional information the FTC's new Franchise Disclosure Document will require relative to that required by the prior Uniform Franchise Offering Circular format. Of the additions, we have identified the following as those that may require the most advance preparation, information gathering, or tracking:

- **Parent Disclosure.** At minimum, franchisors will be required to disclose the name and address of their corporate parent in Item 1. In certain circumstances, disclosure of other information about the parent and perhaps the parent's financial statements may be required.
- **Non-Employees.** Item 2 will now require inclusion of all individuals who have management responsibility over franchise sales or operations. It is not clear whether officers, employees, or other representatives of a parent or affiliate will be included. We are hoping for further clarification in the FTC's Compliance Guides.
- **Litigation.** Litigation disclosure (Item 3) is expanded in three ways:
 1. Parent or affiliated entities who induce franchise sales by promising to back the franchisor financially or otherwise guarantee performance are added to the list of entities subject to full litigation disclosure;
 2. Material civil actions involving the franchise relationship (contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business) in the last year, including franchisor initiated actions where there are no counterclaims, must now be disclosed; and
 3. Required categories of injunctive orders or decrees must also be disclosed for any affil-

ate that offered or sold any franchise within the last 10 years, not just franchises sharing the franchisor's principal mark.

- **Bankruptcy.** Bankruptcy disclosure (Item 4) is now required for the parent entity and all other individuals with management responsibility relating to franchise sales or operations.
- **Additional Funds.** Gone are the days of the boilerplate. Now, Item 7 must include a description of the factors, basis, and experience that the franchisor considered or relied upon in formulating the additional funds estimates.
- **Officer Involvement.** The fact that an officer of the franchisor owns an interest in a supplier is now subject to disclosure in Item 8. At the moment, there are no limits on the extent of the interest, and this could be time-consuming if officers have extensive investment portfolios.
- **System-Wide Disclosure.** Item 20's new format doesn't really call for new information, but it calls for a reclassification, which may result in historical detective work to determine how to classify certain system changes, particularly in light of the new "last occurrence" rule. This rule, intended to avoid double counting system changes (a noted defect in the prior UFOC Guidelines) requires system changes to be classified by the last occurrence during the disclosure period, with footnotes explaining prior occurrences during the period. Perhaps the most significant Item 20 change is an "anti-churning" provision, requiring disclosure to a prospective purchaser of a particular unit's detailed 5-year ownership history in a supplement or addendum to the disclosure document. Having these records in good form may be very valuable for a system that regularly repurchases and sells units.

Franchisors may improve efficiency in the sales process via early compliance with the new Rule, but it's not right for everyone. Only a careful analysis of the franchised business and its operational capabilities can determine when compliance makes good business sense. If you or a franchisor you know requires guidance on Rule compliance or other franchising-related issues, please don't hesitate to contact us.

About Fox Rothschild’s Franchising & Distribution Practice

Our experienced team consists of approximately 25 attorneys in 8 offices throughout the firm who focus on the many disciplines involved in the business of franchising and distribution. Our clients range from international corporations to entrepreneurial/start-up companies across a variety of industries. As a firm well-versed in this specialized area of law, we are uniquely situated to counsel clients not only because of our significant contacts in the franchising and distribution community but also because of our breadth of experience with entrepreneurial and growing businesses and the people who work with them.

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