The New Franchise Rule and Litigators

Disclosure of Franchisor-Initiated Litigation

Franchisors disclose in Item 3 of their UFOCs those litigation matters involving material claims made against them. Claims made by a franchisor against its franchisees fell outside the Rule’s disclosure requirement. The Amended Rule changes the standard set by both the original Rule and the UFOC Guidelines.

Under Section 436.5(c) of the Amended Rule, a franchisor must now disclose in Item 3 all litigation commenced by the franchisor against its franchisees involving the franchise relationship. According to Section 436.5(c)(1)(ii), a franchisor must disclose litigation in which it:

- was a party to any material civil action involving the franchise relationship in the last fiscal year. For purposes of this section, “franchise relationship” means contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business (such as royalty payment and training obligations). It does not include suits involving suppliers or other third parties, or indemnification for tort liability.

Although the Amended Rule only requires the disclosure of “material” litigation commenced by the franchisor, the commentary to the Rule makes clear that the drafters consider any litigation that touches on the franchise relationship to be material to a prospective franchisee’s decision to enter a franchise system. The Commission declined to impose a threshold level of suits but also declined to require disclosure of litigation by the franchisor’s affiliates, third-party suppliers, or other systems—disclosure that some commenters requested. Viewing materiality from the prospective franchisee’s perspective, franchisor-initiated litigation must now be disclosed in the UFOC. Besides incorporation of a materiality standard, the Commission attempted to lessen the franchisor’s burden in a few respects: (1) The franchisor-initiated lawsuit disclosure requirement “is limited to suits filed in the previous one-year period”; and (2) Item 3 “permits franchisors to report franchisor-litigation annually, not quarterly.”

It is not yet clear how the increased disclosure requirement will affect franchise litigators or their clients. At least two possibilities come to mind. First, at the very least, franchise litigators will be asked to spend more time assisting their transactional colleagues in preparing the disclosures to be contained in Item 3 of the UFOC each year. Requiring the disclosure of litigation initiated by the franchisor will undoubtedly increase the number of cases disclosed.

Second, the Amended Rule may change the way a franchisor decides to conduct litigation. Knowing that all suits it initiates against its franchisees on virtually any subject may ultimately be disclosed in its UFOC, a franchisor may choose to be more judicious in engaging in litigation. On the other hand, it is unlikely that a franchisor would choose not to bring necessary litigation solely because of the new disclosure requirement. Some franchisors will view the amended disclo-

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The New Rule and Your Practice

The Top Ten Things You Need to Know

Gerald C. Wells and Dennis E. Wieczorek

Completing a process that began in the mid-1990s, the Federal Trade Commission (FTC) announced on January 23, 2007, the promulgation of its revised Franchise Rule (16 C.F.R. Part 436—Disclosure Requirements and Prohibitions Concerning Franchising) (the New Rule) replacing the original 1978 Franchise Rule (the Old Rule). Franchisors must comply with the New Rule no later than July 1, 2008, but may do so as early as July 1, 2007.

Compliance with the New Rule appears to be an all-or-nothing proposition; a franchisor cannot cherry-pick specific provisions and ignore the remaining requirements of the New Rule, even during the voluntary compliance phase. The FTC also confirmed that outbound international transactions, where the franchise will be located or operated outside the United States and its territories, are not covered by the New Rule. Finally, the FTC has initiated a rulemaking to create a separate rule regulating business opportunities, thereby removing them from coverage by the New Rule.

What follows are our views on the Top Ten developments in the New Rule. A more detailed review and analysis will appear in the next Franchise Law Journal.

#10 No Broker Disclosures—But Will the States Follow?
The New Rule deletes all disclosures regarding brokers or referral sources used by the franchisor in the sales process. Although this will help to reduce the size of some disclosure documents, brokers still remain liable for fraudulent conduct under Section 5 of the FTC Act and otherwise under common law.

The more interesting question is whether state franchise regulators will accept the FTC’s decision. The New Rule (like the Old Rule) preempts inconsistent state regulations, but not more rigorous state requirements. Some franchise regulatory states

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New Franchise Rule Eases International Franchising

Carl E. Zwisler

International franchisors on both sides of the U.S. border will benefit from changes to the FTC’s Franchising Trade Regulation that was published January 23 (Amended Rule). As of July 1, 2007, franchisors may take advantage of the changes. By July 1, 2008, all franchise disclosure documents used in the United States must make disclosures that comply with requirements in the Amended Rule. The Amended Rule largely adopts the Uniform Franchise Offering Circular (UFOC) and modifies it to make it more relevant to current franchising practices.

Franchises granted for locations outside the United States are not subject to the Amended Rule. Although the FTC Rule’s application to foreign franchise sales has been questioned for years, the Amended Rule eliminates concerns that U.S. franchisors must deliver “plain English” disclosures to foreign prospective franchisees, regardless of the requirements of laws in their home countries.

The FTC does not purport to have the authority to preempt states from exercising jurisdiction over franchise sales made by resident franchisors to prospective franchisees in other countries. Thus, U.S. franchisors still must evaluate whether franchise and business opportunity sales laws in their states require registration and disclosure to prospective foreign franchisees, regardless of the requirements of laws in their home countries.

State franchise laws approach regulation of foreign franchise sales in different ways from the Amended Rule. Five states—California, Hawaii, Indiana, Maryland, and Michigan—do not impose registration or disclosure obligations on franchisors selling franchises for locations outside their states as long as the prospective franchisees are not domiciled in the registration state. Franchise laws in six

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**What You Need to Know** (continued from page 163)

may determine that broker, and other, disclosures should be required notwithstanding the FTC’s contrary views (also note the discussion below regarding disclosure document delivery rules).

### #9 Parent Company Information—A Moving Target

Parent company information must be provided in various disclosure items but certainly less obtrusively than in previous drafts of the New Rule. Item 1 parent disclosures are limited to identifying the parent companies and their principal business addresses, in contrast to the more detailed disclosures about affiliates and predecessors. Item 3 litigation disclosures are required under the New Rule only for a parent who “induces franchise sales by promising to back the franchisor financially or otherwise guarantees the franchisor’s performance.” Similarly, a franchisor must disclose a parent’s financial statements when the parent commits to perform post-sale obligations of the franchisor or guarantees obligations of the franchisor. The New Rule also requires the franchisor’s parent’s bankruptcy history to be disclosed in Item 4.

### #8 Franchisee Associations Get Publicity

The New Rule requires that franchisors disclose the name, address, telephone number, e-mail address, and web address for trademark specific franchisee associations. All franchisee associations that are created, sponsored, or endorsed by the franchisor must be disclosed. Franchisee associations that are independent must be disclosed only if the association (1) is incorporated or otherwise organized under state law and (2) asks the franchisor to be included in the disclosure document during the next fiscal year. Independent franchisee associations must annually renew their request to be included in the disclosure document no later than sixty days after the close of the franchisor’s fiscal year.

### #7 The Gag Rule

Franchisees agree to confidentiality provisions in a wide variety of contracts with franchisors, perhaps most often in connection with the settlement of disputes. The FTC is concerned that confidentiality provisions gag existing franchisees from talking to prospective franchisees. Accordingly, the New Rule requires that franchisors disclose the existence of gag clauses with specific prescribed language, but does not prohibit them. At its option, the franchisor may disclose the number and percentage of franchisees that have agreed to such confidentiality provisions and may describe the situations in which such provisions were signed.

### #6 Franchisor Claims Are Disclosable (But Only a Little)

Material franchisor-initiated litigation against franchisees involving the franchise relationship is now required to be disclosed in Item 3. The “franchise relationship” is defined as “contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business (such as royalty payment and training obligations).” The FTC excludes suits involving supplier or other third parties or tort indemnification. In order to minimize compliance burdens, the franchisor-initiated litigation disclosure requirement in the New Rule (1) is limited to suits pending in the previous one-year period, (2) only requires an annual update to such litigation, and (3) must meet materiality requirements.

Franchisors may provide basic, summary information on franchisor-initiated litigation without the typical extended discussion on each case, including listing these suits under one common heading as the case summary. The filing of a counterclaim by a franchisee in a franchisor-initiated litigation matter takes the matter outside the franchisor-initiated litigation disclosure requirement, and the franchisor must comply with the general litigation disclosure requirement.

### #5 Earnings Claims Ain’t What They Used To Be

The term “earnings claims” has been a misnomer for years because rarely are earnings the subject of such claims. The FTC opted to use new terminology, and earnings claims are now “financial performance representations.”

But the FTC did more than change nomenclature. It now requires that specific language be used in the disclosure document to clarify that franchisors are allowed to make these representations (to counter sales presentations that may incorrectly state that the FTC prohibits financial performance representations). Also, if the franchisor makes no representations at all in Item 19, the New Rule requires a statement that franchisees should not rely on unauthorized representations and should report them to governmental authorities. In addition, the FTC retracts requirements from the Old Rule that Item 19 disclosures comply with generally accepted accounting principles (GAAP) and be geographically relevant.

The most significant change to Item 19 in the New Rule is the FTC’s conclusion that the franchisor’s disclosure of expense information above does not constitute a financial performance representation under Item 19. Thus, sales, profits, earnings, and similar indicia of financial performance are subject to Item 19 requirements, but costs and expenses are not.

### #4 Exemptions May Help in Limited Circumstances

The New Rule includes exemptions that are similar to those used in some state franchise laws. However, note that disclosure compliance (and registration) will be required in any franchise regulatory state if the FTC and state exemptions do not match up. The new exemptions are:

(a) A large franchise investment exemption applies where the prospective franchisee (i) makes an initial investment totaling at least $1 million excluding the cost of unimproved land and funds obtained from the franchisor (or an affiliate) and (ii) signs an acknowledgment confirming the facts in (i). If the prospective franchisee is an investment group (e.g., joint venture or outside equity investors) purchasing the franchise, then at least one individual in the group must qualify as a sophisticated investor by investing at least $1 million. For purposes of the large franchise-investment exemption, a multijurisdiction franchisee investing $1 million or more in a number of units satisfies the required initial investment.

(b) The large franchisee exemption applies where a franchise sale is made to an ongoing entity with at least $5 million net worth and five years of prior business experience. An individual may qualify for the exemption but the individual must satisfy the net worth and business experience thresholds. The entity or individual does not need business expe-
The principal benefit of this change is to allow electronic disclosure, which is less expensive and more flexible than hard-copy disclosure. The delivery requirement under the New Rule can be accomplished by delivering to the prospective franchisee (i) the disclosure document by hand delivery, fax, email, or otherwise delivering by the required date, (ii) directions for accessing the disclosure document on the Internet by the required date, or (iii) a paper or tangible electronic copy (e.g., computer disk or CD-ROM) by first class U.S. mail at least three days before the required date.76 As part of the requirements to furnish disclosure, the New Rule also requires the franchisor to notify the prospective franchisee in advance of any prerequisites for obtaining the disclosure document in a particular format and any prerequisites for reviewing the document in a particular format such as software, bandwidth, or other computer requirements.48 Additionally, the disclosure document must be in a form that permits the prospective franchisee to store, download, print, or otherwise maintain the document for future reference.49

Endnotes

2. Amended Rule § 436.2.
4. Amended Rule § 436.5(b).
6. Amended Rule § 436.5(a).
7. Id § 436.5(c)(1).
8. Id § 436.5(u)(1)(v).
9. Id § 436.5(d)(1).
10. Id § 436.5(u)(8).
11. Id § 436.5(c)(8)(ii).
12. Id.
15. Id.
16. Id § 436.5(c)(1)(ii).
17. Id.
18. Id.
19. Id.
20. Id § 436.5(c)(4).
22. Amended Rule § 436.1(e).
23. Id § 436.5(s)(2).
24. Report, supra note 1, at 158.
25. Id at 34–36.
26. Id § 436.5(s).
27. Id § 436.8(a)(5)(i).
28. Id.; Report, supra note 1, at 231.
29. Report, supra note 1, at 231.
30. Amended Rule § 436.8(a)(5)(ii).
32. Page 233.
33. Page 236.
34. Amended Rule § 436.8(a)(6).
35. Id.
36. Amended Rule § 436.5(t).
37. Id § 436.5(t)(2)(ii)(E), (F) and (G).

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New Franchise Rule and Litigators
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sure guidelines as a positive development, as prospective franchisees will be placed on notice from the beginning of the franchise relationship that the franchisor takes their contractual obligations seriously.

In a close case in which the franchisor is not sure whether litigation is its best recourse, the new disclosure requirement could tip the balance in favor of a negotiated solution. Franchise litigators should be familiar enough with the new Rule’s disclosure requirements to advise clients accurately about this issue before filing a lawsuit.

Disclosure of Settlement Agreements
The original Rule required franchisors to disclose any civil action in which the franchisor had settled out of court with a franchisee in the previous seven fiscal years, provided that settlement was deemed unfavorable in some way to the franchisor. It did not distinguish between those settlements that were confidential and those that were not. Settlements in favor of the franchisor were exempt from that portion of the disclosure. The Amended Rule continues to require disclosure of settlements not favorable to the franchisor, but expands the disclosure requirement to include those settlements deemed “confidential” by the parties. Under the Amended Rule, whenever a franchisor enters a settlement agreement that could be construed as unfavorable to the franchisor, i.e., where the franchisor pays money, provides some material value to a franchisee, or foregoes some enforceable right, that settlement agreement must be disclosed, even if the parties expressly agree to keep its terms confidential.

Franchise litigators should advise their clients of the possibility that even a confidential settlement agreement may be disclosed. A franchisor willing to settle a franchisee dispute by permitting one of its franchisees to deviate from obligations required of the rest of the franchise system must evaluate that decision in light of the requirement that the terms of the settlement will become public knowledge. It is not hard to imagine some situations in which a franchisor might be reluctant to make the terms of a settlement agreement available to both prospective franchisees and other franchisees currently in its system. Of course, those franchisors that comply with the UFOC Guidelines should have already made such disclosures for a number of years. Thus, the Amended Rule will require litigators to have a frank discussion about this issue with those clients who have not previously disclosed such settlements.

The Amended Rule requires franchisors to disclose in Item 20 whether any franchisee in the previous three years was required to sign a confidentiality clause in a franchise agreement, settlement agreement, or any other contract. In fact, the Amended Rule mandates that specific language be contained in Item 20 to alert prospective franchisees to the existence of such clauses. Item 20 must provide that: “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.”

Franchisors will want to consider the impact of such language on their ability to attract future franchisees before they require current franchisees to accept confidentiality clauses.

Franchisee Associations
Another area in which the Amended Rule imposes a new requirement is the disclosure of franchisee associations. Item 20 must now contain a disclosure of a franchisee organization’s name and contact information if the organization is created or endorsed by the franchisor or if the organization asks to be included in the franchisor’s UFOC.

In isolation, this disclosure requirement seemingly will have little impact on franchise litigation. Given the sometimes contentious relationship between franchisors and their franchisee associations, however, this change has the potential to create conflict as prospective franchisees begin to contact the leadership of those associations. If those associations are unhappy with the franchise relationship, they may persuade prospective franchisees to forego entering into a franchise agreement. If that is the case, the prospective franchisee may not have been the best fit for the company in any event. Many franchisors consider this development to be a potential benefit, however, because potential franchisees will actually speak with the leaders of the franchisee associations prior to purchasing the franchise. Those discussions may eventually lead to litigation if the information provided is not truthful, or in cases where it amounts to tortious interference with prospective contractual relations.

The No Disclaimer Rule
Section 436.9 (h) prohibits “franchise sellers from disclaiming or requiring a franchisee to waive reliance on any representation made in a disclosure document or any of its exhibits or attachments.” There is candid discussion of the problems cited by many franchisee advocates by which “sophisticated integration, no representation, and no reliance clauses . . . stripped franchisees of all fraud claims.” Some commenters encouraged a broad prohibition against disclaiming any authorized statement—whether in the UFOC or other promotional materials. The FTC declined to implement this suggestion. The prohibition against use of disclaimers extends, however, not only to the UFOC, but to its exhibits and attachments. In addition to financial statements, exhibits include all form agreements a franchisee may sign, including real property leases, equipment leases, financing documents, software licenses, etc. Some of these documents are provided by third parties. Although most franchisors agree that they do not want to disclaim anything that is contained in their disclosure documents and have practiced that way for years, the added requirement regarding the prohibition against disclaimers of any third party documents could lead to potential litigation.

This quick review certainly does not serve as a substitute for thorough study of the Rule itself. Although most franchisors will turn to their transactional counsel to address most issues, franchise litigators should be aware that the Amended Rule may well affect the way their clients view, and the decisions they make about, litigation.

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states—Illinois, New York, North Dakota, Oregon, South Dakota, and Washington—would allow a franchise sale for a foreign location to be made by a resident franchisor, only if the franchisee is not domiciled in the state and an offer or sale of the franchise is not made there.

Generally, that would preclude the prospective franchisee from visiting the franchisor’s headquarters before a franchise agreement is executed, and would preclude a franchisor from accepting or executing the franchise agreement in its home office. Minnesota and Rhode Island exclude franchises from registration and disclosure if the franchise is for a foreign location and the prospective franchisee is neither domiciled in the state nor “actually present” in the state. This language appears designed to circumvent arguments that a franchisor thought a prospective franchisee was a resident of the state but actually was domiciled elsewhere, e.g., in the country where the franchise is to be granted.

As Table 1 illustrates, only the Virginia franchise law provides an exclusion from compliance with disclosure regulations that is as far reaching as the FTC’s foreign franchise sale exclusion.

Most franchisors whose principal trademarks are registered with the U.S. Patent and Trademark Office, or that comply with the franchise sales law in a state having both a business opportunity law and a franchise sales law, are excluded or exempt from compliance with state business opportunity laws. However, in some states, such as Iowa, Ohio, Oklahoma, Nebraska, and Texas, franchisors are exempt from complying with business opportunity laws only if they comply with the FTC Rule, or deliver a UFOC to prospective franchisees that meets the standards prescribed by NASAA in its UFOC Guidelines.

Franchisors residing in those states that wish to avoid making UFOC-type disclosures to foreign franchisees will soon be faced with the question: is meeting an exemption standard or satisfying the Amended Rule’s exclusion for foreign franchise sales the same as “fully complying” with the FTC Rule? Is not having to comply the same as “complying in all material respects” with the Amended Rule for purposes of meeting the state exemption standards? Those questions will need to be addressed on a state-by-state basis.

For franchisors based outside the United States, the Amended Rule offers many advantages over the current FTC Rule. The advantages include

- Elimination of the “first personal meeting” disclosure requirement;
- Elimination of a duty to provide a completed copy of a franchise agreement to a prospective franchisee five business days before it may be executed;
- Exemptions from any form of compliance for transactions involving franchisees making large investments, franchises granted to managers and owners of franchisors;
- Relaxation of the obligation for all disclosure documents to include financial statements of franchisors that are prepared according to U.S. accounting standards; and
- The ability to make disclosure electronically, e.g., via e-mail or Internet download.

First Personal Meeting Disclosure Requirement Is Revoked

Franchisors will find that the Amended Rule makes testing American interest in their franchise offerings much easier. Under the current Rule, franchisors must deliver disclosure documents to a prospective franchisee at the “first personal meeting.” Under the Amended Rule, disclosures must be provided at least fourteen calendar days before a prospective franchisee pays any money to the franchisor or its affiliate in connection with a franchise acquisition, or fourteen calendar days before any agreement relating to the franchise purchase is signed.

The current Rule restricts franchisors from participating in trade shows in the United States or from talking seriously with prospective franchise partners unless they have first compiled a disclosure document (Uniform Franchise Offering Circular or UFOC), prepared compliant audited financial statements, and delivered them to prospective franchise partners no later than at their first in-person meeting to discuss a possible franchise relationship. UFOCs also must include copies of standard franchise agreements franchisees are expected to sign. Given the typical legal and accounting cost of developing these documents, many foreign franchisors have understandably devoted their foreign development budgets to places where a franchise “fishing license” could be acquired at a lower expense. The revised requirements of the Amended Rule will permit foreign companies evaluating franchising in the United States to delay preparing UFOCs and franchise agreements until they have found a serious candidate.

The elimination of the first personal meeting rule also may

\textbf{CHART 1}
substantially facilitate a franchisor’s ability to comply with disclosure requirements. One of the most frustrating disclosure requirements for a foreign franchisor is the need to estimate the startup expenses a new franchisee will incur. A company with no U.S. operational experience usually only can compile the information through expensive market research. Once the information is included in a UFOC, it is always likely that the nature of the franchisee’s investment will change from what was disclosed, based on the terms of the franchise agreement negotiated. Under the Amended Rule, the parties can first determine whether they will expand through unit franchising, area development franchising, or master franchising, and then agree upon any modifications to the franchisor’s prototype business they want to make before the franchisor must place the information in a disclosure document. If the prospective franchisee and the franchisor work together on market studies, the cost of the market research may be less, and the estimates may be much more accurate.

Electronic Disclosure Is Approved
The Amended Rule specifically permits the use of electronic means, such as email, website downloads, or compact discs, to deliver disclosure documents. This change can expedite and reduce the cost of the franchise recruitment process, especially when the franchisor’s headquarters are outside the United States. No longer will franchisors need to bear the expense of international couriers or wait for international mail to be delivered to satisfy disclosure requirements.

Amended Franchise Rule Exemptions
Although the Amended Rule does not provide any specific exemptions for foreign franchisors, three new exemptions may provide a basis for many foreign-based franchisors to avoid the Amended Rule altogether. The Amended Rule exempts franchise offers made to “sophisticated investors” — those that have been in business for at least five years and have a net worth of at least US$5 million. Only one member of an investor group needs to meet the requirement for the exemption to be applicable. Thus, prospective franchisees with established regional or national businesses may be granted franchises without the need for a disclosure document, audited financial statements, or other documents usually required by the Amended Rule.

Also exempt are franchisees requiring investments exceeding US$1 million, excluding the cost of unimproved land and any financing provided by the franchisor. In calculating the investment, franchisors may include the expenses and fees associated with establishing franchised outlets under multiunit franchise agreements such as area development agreements and master franchise agreements. Prospective franchisees who agree to convert existing business operations to a franchise also may include the value of their business assets in the calculation of the amount they are investing in a franchise.

Finally, franchises sold to officers, owners, or managers of a franchisor that have been employed by the franchisor for at least two years before purchasing the franchise will be exempt. This will allow a company-owned prototype franchise or a joint venture formed to enter the U.S. market to be sold as a franchise after two years to an employee without the need for FTC disclosures. It also would permit a franchisor to avoid the Rule by selling a franchise to a U.S. entity that “is at least 50 percent owned by a person who, within sixty days of the purchase of the franchise, has been, for at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor’s franchises or the administrator of the franchised network.”

In addition, the exemption applies to a person who has owned at least a 25 percent interest in the franchisor for a two-year period, ending no later than sixty days before the franchise sale. This should facilitate franchise sales where a member of a franchisor’s management or ownership team will take a 50 percent “ownership interest” in a U.S. franchise. The Amended Rule would not prohibit the other owners from having voting control over the franchise entity, or from investing a majority of the capital needed to acquire the franchise and launch the franchised business.

Financial Audit Requirement Changes
One of the principal roadblocks for some foreign franchisors is the FTC’s audit requirement. Disclosure documents must include audited financial statements of the franchisor and audits must be performed in accordance with U.S. generally accepted auditing standards (GAAS). The Amended Rule relaxes this requirement somewhat and allows foreign companies to use statements prepared under their country’s generally accepted accounting principles (GAAP), so long as the statements also satisfy criteria published by the U.S. Securities and Exchange Commission (SEC) for the use of foreign financial statements in U.S. securities offerings. Whether franchisors can find accounting firms willing and able to modify existing statements to meet the SEC criteria in a cost-effective way is an open question.

The Amended Rule permits companies that are “new to franchising,” which have not previously had an audit, to phase in to the audit requirements. Rather than being required to provide three years of balance sheets, profit and loss statements, and cash flow statements, “startup franchisors” only are required to prepare audited statements after the end of the first fiscal year in which they begin franchising. New franchisors must include in their disclosures unaudited statements that have been prepared in accordance with U.S. GAAP.

It is not clear whether a company that has only offered franchises outside the United States will be considered a “startup franchisor” or “new to franchising.” It is also unclear whether a company that has had audited financial statements prepared under its home country’s GAAP will qualify for the audit requirement phase-in. Those issues should be resolved when the FTC releases its compliance guides before the Amended Rule becomes effective.

Foreign franchisors will need to carefully consider how they structure the entity that will offer franchises in the United States. The audited financial statements of a franchisor’s parent company must be included in the disclosure document if the parent company commits to perform the franchisor’s post-sale obligations to franchisees or if the parent guarantees obligations of the franchisor subsidiary. In the past, some foreign franchisors have set up new
companies to grant franchises in the United States in order to minimize tax liability, exposure to claims from U.S. franchisees, or audit costs. Under the Amended Rule, establishing a new entity to be the franchisor for the United States could result in the parent company having to provide its financial statements, unless it clearly arranges for the franchisor entity to perform services for U.S. franchisees. Parent company guarantees are sometimes required by state franchise examiners as a condition of registering franchise subsidiaries and are required by the Amended Rule if the franchisor does not have its own audited financial statements and relies upon its parent’s audited consolidated statements.

Negotiating Franchise Terms Is Easier

Under the current Rule, a prospective franchisee must have a completed copy of the franchise agreement and all agreements related to the franchise purchase in its hands for five business days before he can sign them. If the parties change terms of the standard agreement—especially if the changes benefited the franchisor—the five-business-day waiting requirement is renewed. Businesspeople who often travel far to close deals and who are accustomed to negotiating changes in deal terms up to the time an agreement is signed have found the process to be thoroughly frustrating. Under the Amended Rule, unless the franchisor unilaterally changes the form of agreement that is included with the disclosure document, and requests the prospective franchisee to sign that changed version, the parties do not need to wait to conclude a deal—assuming they already have complied with the fourteen-day presale disclosure requirement.

State Regulations Remain in Place

The Amended Rule applies to all franchises offered for sale for locations in the United States. However, franchise sales laws in fourteen states also regulate offers and sales of franchises, by their residents to their residents, and sometimes to nonresidents if franchised locations will be established in those states. Under the Amended Rule, the state regulators may impose higher standards of disclosure than the Amended FTC Rule prescribes. At a minimum, these states will require that franchisors either “register” their franchises under their laws or submit applications for exemptions from the laws, even if the franchisors qualify for exemptions under the Amended Rule. Some franchise registration laws exempt franchise transactions that are similar to the Amended Rule’s exemptions, although none of the exemptions is identical to the exemptions in the Amended Rule.

Additionally, franchisors lacking a U.S. trademark registration also may be required to comply with filing and disclosure requirements of Business Opportunity Sales Laws (Biz Opp) that exist in twenty-six states. Compliance with Biz Opp laws usually involves filing a brief disclosure statement (which is much less detailed than a UFOC) and the payment of a filing fee, which rarely exceeds $100. Without detailing specific requirements and exemptions of state franchise and business opportunity laws, the FTC Rule is the only law that specifically regulates the sale of franchises in eighteen states, Washington, D.C., and Puerto Rico.

Conclusion

Although international franchising was only a small part of the FTC’s focus when revising the Rule, there is little doubt that the changes the FTC has adopted will lower barriers to international franchising across America’s borders. The biggest beneficiaries are franchisors based outside the United States. Assuming they can surmount recent obstacles imposed by the U.S. Citizenship and Immigration Service and actually visit the country, expect to see a growing number of foreign franchisors at U.S. trade shows and on U.S.-targeted Internet sites in the coming months.

Endnotes

1. The Amended Rule, “Disclosure Requirements and Prohibitions Concerning Franchising,” was published January 23 in a 398-page document, which includes the Statement of Basis and Purpose, the Amended Rule itself, and a new part, 436.7, “Disclosure Requirements and Prohibitions Concerning Business Opportunities.” This article only deals with the amended franchise rule. Page references, where provided, are to the 398-page document [hereinafter the Report]. The Report is available at www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf. The effective date is on page 1 of the Report.

2. Id.

3. Id. at 3.


5. See, e.g., Nieman v. Dryclean U.S.A. Franchise Co., Inc., 178 F.3d 1126 (11th Cir. 1999), in which the court concluded that the FTC was not granted authority by Congress to regulate franchise sales outside the United States.

6. Amended Rule § 436.10(b). “The FTC does not intend to preempt the franchise practice laws of any state or local government, except to the extent of inconsistency with this Rule.”

7. See, e.g., California Franchise Investment Law, CAL. BUS. & PROF. CODE §§ 31013, 31018.

8. Examples of business opportunity laws that do not apply to franchise grants that include the license of a trademark registered with the U.S. Patent and Trademark Office include Connecticut (CONN. GEN. STAT. §§ 36b-60 through 36b-80), Florida (FLA. STAT. ch. 559.80–559.815), Georgia (GA. CODE ANN. §§ 10-1-440 through 10-1-447), and North Carolina (N.C. GEN. STAT. §§ 66-94 through 66-100). Examples of business opportunity law that exclude franchisors subject to the state’s franchise sales law include California (CAL. CIV. CODE §§ 1812.200–1812.221 (West)), Illinois (815 ILL. COMP. STAT. 602/5-1 through 602/5-135), Indiana (IND. CODE § 24-5-5), and Maryland (Md. CODE ANN., BUS. REG. §§ 14-101 through 14-129).

9. CAL. COMP. CODE § 31105 (West); HAW. REV. STAT. § 482-E-4(4); 815 ILL. COMP. STAT. 705/10; IND. CODE § 2; MD. CODE ANN., BUS. REG. § 02.02.08.10(B); MICH. COMP. LAWS § 445.1506(6)(1)(d); MINN. STAT. § 80C.03(h); N.Y. GEN. BUS. LAW §§ 681(12)(a), 682 (McKinney); N.D. CENT. CODE § 51-19-02(14)(b)(1); OR. REV. STAT. § 650.015(1); R.I. GEN. LAWS § 19-28.1-7; S.D. CODIFIED LAWS § 37-5A-7.1 (Michie); VA. CODE ANN. § 13.1-559(B) (Michie); WASH. REV. CODE § 19.100.020; and WIS. STAT. § 32.05(1)(d) (West).

10. The franchise exemption in the Ohio Business Opportunity Sales Law exemplifies this issue. Under the Ohio Law, franchise sales are subject to the disclosure requirements unless the sales comply with the FTC Rules. See Ohio Rev. Code Ann. § 1334.13 (LexisNexis 2006).


The Amended Rule does not require a franchisor to “comply” if it is exempt or if it sells franchises for foreign locations.

12. Amended Rule § 436.2(a).

What You Need to Know (continued from page 165)

38. Id. § 436.5(o).
39. Id. § 436.5(2)(i).
40. Id. § 436.5(2).
41. Id. § 436.2(a).
42. Id. § 436.9(e).
43. Current Rule § 436.1(g).
44. Report, supra note 1, at 71.
45. Amended Rule § 436.2(b).
46. Id. § 436.2(c).
47. Id.
48. Id. § 436.2(c)(2).
49. Report, supra note 1, at 200.

New Franchise Rule and Litigators (continued from page 166)

2. Id. at 102.
3. Id.
4. Id. at 102-03.
5. Id. at 106.
6. Id. at 108-09.
7. Id. at 98.
8. Id.
9. Id. at 99-100.
10. Id. at 100.
11. Id. at 171.
12. Id.
13. Id. at 177.
14. Id. at 243.
15. Id. at 250–58.
16. Id. at 256.
17. Id.