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FTC Issues FAQ Advising Franchisors to Adhere to One Regulator's Item 19 Comments in All States

On July 2, 2014, the Federal Trade Commission ("FTC") issued Amended Franchise Rule FAQ 38. [1] FAQ 38 has not received much attention, perhaps due to the fact that the FTC's website for posting FAQs has recently changed. In any event, FAQ 38 attempts to give extra-territorial effect to one state regulator's comments on a single issue, an Item 19 financial performance representation (formerly known as an earnings claim) ("FPR"), by singling out a regulator's comments concerning Item 19 FPRs and admonishing that the changes requested by the regulator (1) should be adopted, and (2) should be incorporated in all versions of the franchisor's franchise disclosure document ("FDD") and used in all states. The threatened consequences for not using the single regulator's required FPR in all states (or for withdrawing the state application to avoid making the requested changes), is that it will call into question whether the FPR meets the requirements of the FTC Franchise Rule, and particularly whether the franchisor has written substantiation demonstrating that the FRP has a reasonable factual basis. FAQ 38 concludes by backtracking a little bit by first acknowledging that whether or not a franchisor uses the same FPR in each state will not really change the franchisor's burden of substantiating its FPR, but repeating a threat that failing to follow a regulator's direction on the FPR may expose the franchisor to "the risk of heightened scrutiny by federal or state franchise law enforcers."

Why did the FTC issue FAQ 38, and what might it signal for the future? One answer could be that the FTC and the state regulators are trying to reinforce the authority of the state examiners, and perhaps, to deputize certain more aggressive examiners as the leading enforcers and interpreters of the FTC Franchise Rule. A related answer could be that the FTC and state regulators are also trying to eliminate the opportunity for franchisors to disagree with a particular state examiner's comments by maintaining a separate FDD for use in the state making the disputed comments in order to get the FDD registered in the state, and go about their business with their original language in other states. Because FPRs are considered material (if made) and easy to isolate in the FDD, the FTC could be starting with Item 19, but could expand this concept and in the future require that a broader scope of state regulators' comments should be adopted nationwide.

The opening statement in FAQ 38 that ordinarily a franchisor should incorporate revisions made to the FDD in response to an examiner's comments and adopt those revisions for use everywhere is at first blush not controversial. Many may go so far as to consider such adoption to be a best practice. After all, examiners often make constructive comments and it is wise to take advantage of their review and adopt the revisions universally in all versions of the FDD. That said, we see potential flaws in FAQ 38.

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Examiners are not always in agreement concerning their comments, and it is possible to receive inconsistent or conflicting comments from different state examiners. While often state examiners will cooperate and help resolve conflicts between their comments and reach a common understanding with the franchisor, state examiners are not required to agree with each other and may maintain their separate views or enforce their differing state policies.

In our experience, comments on the Item 19 FPR frequently have more to do with format or the presentation of information and disclaimers and do not often go to the issue of whether the franchisor has substantiation for the FPR. For example, Maryland required that one FPR contain separate charts of performance data for company-owned units and franchisee-owned units and could not combine data on both types of units in one chart, even though all of the other states accepted the same FPR charts combining company-owned and franchisee-owned units. Maryland examiners have also been aggressive in requesting certain language be deleted because they deem the language to be a disclaimer. FAQ 38 requires that a franchisor adopt Maryland's revisions for use in all states. But the changes Maryland frequently requests to Item 19 arguably do not go to whether the franchisor has a reasonable factual basis for its FPR, which is the rationale the FTC uses in FAQ 38 for trying to mandate that franchisors must adopt one state's comments on the FPR in all states. If an examiner's comment actually concerns the issue of whether the franchisor has substantiation for the FPR, it would appear to make sense that the comment should be addressed for all states. But FAQ 38's broad characterization that all comments concerning the FPR must

be adhered to for all states because they question the factual basis of the FPR seems conclusory and overbroad.

Finally, what is the logistical impact of FAQ 38 on franchisors? A material amendment to the FDD requires that the franchisor file an amendment in a registration state (unless exempt or a filing is not otherwise required by the state). Typically, a franchisor's responses to state examiners' comments in the registration or renewal process are considered not to be material, and franchisors are encouraged to file a copy of the final FDD resulting from all state comments when the process has concluded, as a courtesy, but not to file a formal amendment (with the attendant fees and forms). By admonishing that all comments to Item 19 must be adopted in all states because they purport to go to the issue of whether the franchisor has substantiation for the FPR, FAQ 38 could be read to suggest that the revisions to Item 19 are material, and would therefore require a formal amendment with the registration states, where applicable. This interpretation would be an expensive and time-consuming impact of FAQ 38, delaying resumption of sales in the affected registration states while the new amendment, most likely a post-effective amendment because these other states may have already approved the FDD, must be reviewed and declared effective.

FAQ 38 was issued quietly and has received no fanfare in six months. Nevertheless, we believe FAQ 38 may be a signal of even greater state cooperation in terms of enforcement of each other's FDD comments, and may cause greater expense and delays to franchisors in registering, renewing or amending their FDD when comments on Item 19 are issued.

[1] <http://www.business.ftc.gov/documents/amended-franchise-rule-faqs>

38. If a franchisor is unable to register a franchise offering in a state with a franchise registration law without removing or altering a Financial Performance Representation ("FPR") in Item 19, may the franchisor use the unaltered FPR in the Franchise Disclosure Document ("FDD") it delivers to potential purchasers in other states?

Answer: If a franchisor revises its FDD at the request or direction of one registration state, it ordinarily should incorporate the same revisions in the FDDs it uses in other registration and non-registration states to ensure that its disclosures are complete and accurate. In the case of an FPR in Item 19 questioned by one registration state, a failure to make any resulting voluntary or involuntary changes to the FPR in all other states, or abandonment or withdrawal of the registration application without making changes, will raise significant concerns about whether the FPR meets the requirements of the Franchise Rule. In particular, any such failure will call into question whether an FPR meets the requirement that a franchisor have written substantiation demonstrating that its FPR had a reasonable factual basis at the time it was made.

As always, the franchisor will bear the burden of proving that its written substantiation shows that factual information in its possession at the time it made the representation supports the FPR as it is likely to be understood by a reasonable prospective franchisee. Any failure to use the same FPR in all states will not change the franchisor's burden, but may expose the franchisor to the risk of heightened scrutiny by federal or state franchise law enforcers.