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Franchise Disclosure Rules Expected to Change— Time for Franchisors to Plan

Adoption of broad amendments to the Federal Trade Commission's Franchise Rule were proposed in a long-awaited FTC Staff Report released on August 25, 2004 after ten years of review. Wiggin and Dana participated in the review process by filing a comment letter on the FTC Staff Report. [<http://www.ftc.gov/os/comments/franrulestaffrpt/index.htm>] Comments in October 2005 by the key FTC Staff member overseeing the review suggest that the FTC is focused on higher priorities and final action on the proposal should not be expected soon. The Franchise Rule requires franchisors to give prescribed information about the franchise offering to prospective purchasers by delivering a presale disclosure document. Copies of the completed franchise documents must also be delivered for inspection before closing the sale of any franchise. A number of states have franchise registration and disclosure laws. Through the North American Securities Administrators Association ("NASAA"), these registration states have adopted a similar but more widely used disclosure format, the Uniform Franchise Offering Circular ("UFOC"). Because the FTC has permitted the use of the UFOC in lieu of its own specified format, but the states have not reciprocated, most franchisors use the UFOC to avoid maintaining two different disclosure documents. The FTC Staff Report proposes adoption of the UFOC as its disclosure standard, but with changes that will require the states and all franchisors to take notice and adapt.

The federal Franchise Rule preempts inconsistent state law, but because the FTC has exercised, and the FTC Staff Report recommends that it continue to exercise only limited federal preemption, states may and have adopted stricter requirements. The FTC Staff Report recommendations would reestablish federal requirements as an important factor in the content of the disclosure, establishing a new disclosure floor through a modified version of the UFOC, sometimes called "UFOC Plus," applicable to all franchisors, but at the same time creating new inconsistencies between federal and state requirements to address.

State regulators, in addition to reviewing the inconsistencies and other issues to be created by the proposed federal disclosure standards, are planning some changes of their own that will affect franchisors' compliance programs and calendars. NASAA reported in its comment letter on the FTC Staff Report that it is working on a change to ease state franchise regulators' franchise renewal season workload by spreading registration renewal due dates evenly throughout the year, perhaps using an alphabetical system by system trademark, instead of most renewals being due in the spring following the common December 31 accounting year end. NASAA's proposal would require annual updates of disclosure information, such as franchisee lists and turnover charts, to be as of three or four months before the new renewal dates, instead of as of the fiscal year end, creating unnatural cutoffs for

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updating certain disclosure information. NASAA hopes to coordinate its changes with the implementation of the FTC changes.

There are some uncertainties about the final form of the revised Franchise Rule and how the FTC and the states will reconcile their differences. The Commission Staff is reviewing the public comments it received and then the Commission is expected to issue the revised Franchise Rule in final form. It is not too early, however, to start planning for the revised Franchise Rule likely to be adopted by the FTC. We expect the work required to revise a disclosure to conform to the new requirements will be significant, but not as burdensome as the changeover to the plain language UFOC format adopted by NASAA in 1993. We will continue to follow the federal and state developments closely.

Our goal in this advisory is to alert you to the more significant changes to the current UFOC proposed in the FTC Staff Report and give you a head start preparing for the updated disclosure rules. This advisory does not attempt to report all of the changes proposed in the voluminous FTC Staff Report. Our advice is subject to change once the FTC has taken final action on the revised Franchise Rule and states have responded.

Disclosure Document and Contract Delivery

There will be significant changes to the current basic rules of when disclosures must be delivered:

- The first personal meeting disclosure trigger will be eliminated as a legal requirement; franchisors may still wish to provide the disclosure at that time.
- The ten business day cooling off period between disclosure and payment of a fee or signing a franchise agreement will be replaced with an easier to calculate fourteen calendar day period.
- The five business day contract review period will be eliminated in the normal

situation; a seven calendar day review period will be imposed if the franchisor makes unilateral and material changes to the sample agreement attached to the disclosure.

Disclosures will have to be provided upon request under the following new disclosure triggers:

- A franchise prospect reasonably requests a disclosure during the "sales process." The FTC Staff Report asserts the new requirement will not mean a franchisor must always deliver a disclosure whenever someone requests, but franchisors should review their solicitation process and where leads come from and determine when the "sales process" begins, or otherwise consider a policy of how to respond to requests.
- A potential buyer (and/or the seller?) of an existing franchised unit requests a disclosure and the disclosure already exists.
- A prospective franchisee, who has already received a disclosure, asks for the most recent version or update. There will be no affirmative duty under the Franchise Rule to distribute updated information unless requested, except for any earnings claims information (called financial performance representations in the proposed Franchise Rule). We caution, however, as acknowledged in the FTC Staff Report, that other important reasons, such as avoiding claims for fraud or misrepresentation, may dictate that prospects should receive updated information before being allowed to purchase a franchise.

Annual Update

The 90-day period to update the disclosure following the close of the franchisor's fiscal year end will be increased to 120 days. Depending on what happens with the NASAA project to spread renewal dates throughout the year as discussed above, franchise companies and their counsel and accountants can expect a little relief in the pressure to

finalize the annual update to the disclosure. This one month extension may be of little consolation for franchisors with more than one franchise system and attorneys and accountants in the field if they have to face the crunch to update disclosures constantly throughout the year if the NASAA proposal is implemented.

Exemptions

Two new sophisticated investor exemptions will help franchise systems with high investment costs or who deal with large companies:

- The large investment exemption will apply where the franchisee's estimated investment, excluding any franchisor or affiliate provided financing and excluding real estate costs (as yet undefined), totals at least \$1 million and the prospective franchisee signs an acknowledgement in a prescribed form confirming the exemption. Franchisors may aggregate the costs to meet the \$1 million threshold if the prospect is planning a multiple unit purchase. Transfers and conversion franchises will be looked at by analyzing the whole investment. If there is a group of investors, at least one will have to be sophisticated by individually investing at the \$1 million level.
- The large entity exemption will apply when the franchisee (its parent or any affiliate) is an entity that has been in business at least five years and has a net worth of at least \$5 million.

Another new exemption for officers and owners will have more limited application. It will apply when one or more purchasers of at least a fifty percent ownership interest in the franchise, within sixty days of the sale, has been for at least two years, (i) an officer, director, general partner, individual responsible for offer and sale of franchises or the administrator of the franchise network, or (ii) an owner of at least twenty-five percent of the franchisor. This will help legitimate future transactions that some may think are company or affiliate-owned units anyway.

*continued***International Locations Excluded**

The Franchise Rule will only apply to franchises located in the United States, its territories or possessions. This will finally resolve a debate whether United States franchise laws apply overseas. U.S. based franchisors that have created disclosures to address the FTC Franchise Rule combined with the disclosure requirements of other countries, especially where no particular form of disclosure is mandated by the other country, must decide on the form of disclosure for these other countries. For the remainder of the world where no disclosure requirements exist, franchisors must decide whether to disclose at all. A disclosure could be seen as a form of insurance against fraud and misrepresentation claims in the future.

Disclosure Content*Item 1: The Franchisor and any Parent, Predecessors, and Affiliates*

- A limited disclosure of the existence of a parent entity that controls the franchisor will be added, hopefully only the ultimate parent company.
- Competition to the franchised business by an entity in which an officer of the franchisor has an interest. This will require franchisors to update their questionnaires for officers and directors to obtain this information.

Item 2: Business Experience

- Biographical information for anyone with management responsibility for the franchisor, even if an officer of a parent or an affiliate only, must be disclosed.
- Disclosure of all franchise broker information will be deleted in Item 2 and franchise broker litigation will not need to be disclosed in Item 3. There is some question whether franchise brokers will have to be listed in the Receipt as provided in the FTC Staff Report.

Item 3: Litigation

- Disclosure of a parent's litigation will be required but only if the parent guarantees the franchisor's performance.
- The disclosure of affiliate litigation will be broadened beyond litigation involving affiliates offering franchises under the franchisor's principal trademark to any affiliate offering franchises under any mark within the past ten years, but only for governmental actions.
- A new disclosure requirement will be added for material franchisor initiated action involving the franchise relationship pending during the last fiscal year, but on a summary basis, listed under a category heading describing the type of suit (for example, royalty collection suits), and containing only the case name, court, and file number.

Item 4: Bankruptcy

- Disclosure of any parent's bankruptcy will be required.

Item 6: Other Fees

- The scope of the disclosure required under Item 6 will require monitoring as the FTC clarifies its requirements. As proposed, Item 6 will include a list of fees a franchisee is required to pay directly to a third party, greatly expanding the listing and challenging franchisors and their counsel to list all operating expenses and possible non-recurring charges.

Item 12: Territory

- If not already included in the franchisor's discussion in Item 12, which it now often is, specific reference will need to be made to franchisor and franchisee rights or limitations to make sales through the Internet, catalog sales, telemarketing or direct marketing.

Item 17: Renewal, Termination, Transfer, and Dispute Resolution

- There will be a new requirement to disclose franchisor policy in the chart summarizing certain franchise agreement provisions if the franchise agreement is silent on a certain provision, with a disclaimer that the policy may change.
- There is also a requirement to explain what "renewal" means, including a statement, if applicable, that franchisees may be asked to sign a contract with different terms. Many franchisors already include a reference to the need to sign a different agreement under their listing of renewal requirements.

Item 19: Financial Performance Representations

- Financial performance representations (earnings claims) will not be mandatory.
- Information on costs will not be "financial performance representations" and will not be subject to the requirements in Item 19.
- Reporting information by subgroups of units will be permitted.
- Financial performance representations made in the general media, including the Internet, will be subject to the requirements of Item 19. Franchisors making financial performance representations, especially public companies reporting financial information on their websites or giving interviews to the general, as opposed to financial press, will need to pay close attention to the Compliance Guides that will be issued to learn the limits of what they can do to inform investors but avoid Franchise Rule restrictions.

Item 20: Outlets and Franchisee Information

- The three tables used for reporting information on franchised outlets and their turnover, company outlets and projected outlet openings will be

replaced by five tables which provide a more logical approach to describing the status of the system.

- New columns of information will require franchisors to track franchised outlets opened, company outlets reacquired from franchisees and company outlets sold to franchisees.
- If multiple events occur to one outlet during a year, only the last event affecting the outlet is to be reflected in the tables, eliminating the double counting issue, but franchisors will have to track the history of events affecting the same outlet within any year, to be able to provide footnotes to explain other changes occurring during the year.
- Systems for recording ownership data for each unit will need to be put in place to comply with a new disclosure requirement for resales of franchised outlets. When a franchisor offers an existing franchised outlet, a chain of ownership for the previous five fiscal years must be given to the prospect as an addendum to the disclosure, including former owners' names, last known addresses and telephone numbers and the reason for the change of ownership.
- A limited mandatory disclosure must be made disclosing whether franchisees have signed confidentiality clauses, whether in a franchise agreement, settlement, or other contract, during the last three fiscal years. The type of confidentiality clause to be tracked is any provision that restricts a current or former franchisee from discussing his or her personal experience as a franchisee with any prospective franchisee, but not including clauses that protect a franchisor's trademarks or other proprietary information. Careful tracking and good inter-company communication within a franchisor organization will be necessary to accurately make the required representation. Optional disclosures will be permitted that required even better

tracking of the number and percentage of current and former franchisees who during each of the last three fiscal years signed confidentiality clauses and the circumstances under which the clauses were signed.

Electronic Delivery

Electronic delivery of the disclosure will be permitted without any requirement to also deliver a paper copy. Delivery options will include delivery as a single document by fax, email, directions for accessing the document on the Internet and an electronic copy (computer disk or CD-ROM). The format must allow a prospect to store, download, print or otherwise be able to retain the document for future reference. Scroll bars, internal links and search features to enhance the ability to maneuver through the electronic version will be permitted, but features to enliven the presentation, such as audio, video, animation or pop-up screens will be prohibited.

A franchisor must also advise the prospect before furnishing a disclosure, presumably in advertising or application materials, of the formats the document may be made available and any computer systems or programs needed to obtain the disclosure in a particular format and any conditions necessary to review a particular format. If the franchisor will voluntarily make the disclosure available in alternative formats, notice of this offer may be given by adding a permitted but prescribed statement on the cover page of the disclosure.

The reference to the prospective franchisee's signature on the Receipt for the disclosure will have a broader meaning, including electronic signatures and passwords. Receipts may be returned by mail, email or facsimile. Representatives, including lawyers and accountants, will be

allowed to receive the disclosure and sign the Receipt on behalf of the prospect. A franchisor's records should reflect the prospect when any representative receives the disclosure.

Integration Clauses

Franchisors will have to review and most likely revise the integration clause in their franchise agreement and related documents. The FTC Staff Report recommends prohibiting a franchisor from requiring a franchisee to disclaim reliance on any representation made in the disclosure.

Conclusion

The revisions to the Franchise Rule expected to be adopted shortly will require all franchisors to make substantial changes to their disclosure documents. Remaining and new differences between the federal and state disclosure requirements will be addressed and resolved to some degree, but we cannot expect uniformity. Franchisors will have to modify their compliance programs, record keeping and internal communications to prepare to meet the revised Franchise Rule's requirements. Franchisors will also have to determine whether to take advantage of electronic delivery methods, new exemptions for sophisticated investors and the absence of U.S. regulation of foreign sales. It will be a busy time for franchise companies and their advisors.

Nothing in this Advisory constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

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