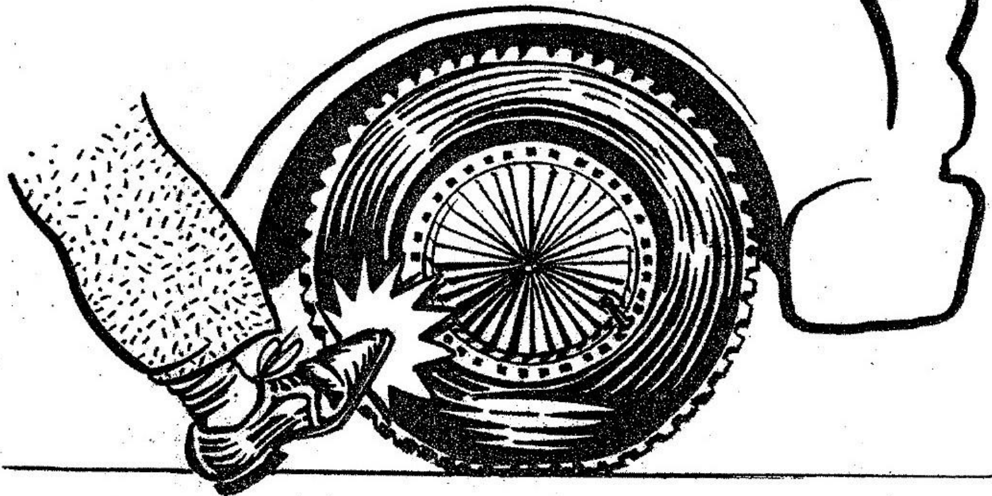
## Trade Regulation

# Caveat Franchisor



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Since the 1970s, the Federal Trade Commission and the state of California have required franchisors to give extensive written disclosures to individuals and companies considering buying a business franchise. The rules cast a wide net, including in their definition of "franchise" many businesses that might not look like typical franchise operations. *Gentis v. Safeguard Business Systems*, 60 Cal.App.4th 1294 (1998) (distributors of record-keeping systems and office products found to be franchisees).

The required presale written disclosure is known commonly as the Uniform Franchise Offering Circular. Presale disclosures help prospective franchisees make informed decisions about whether to invest.

The rules also include a cooling-off period to slow the process of buying a franchise, allowing prospective franchisees to think carefully about their decisions.

The Federal Trade Commission's franchise rules provide guidance in defining a franchise. *Thueson v. U-Haul*, 144 Cal.App.4th 664 (2006) (looking to FTC rule for guidance in defining a franchise).

**Taken as a whole, the new Uniform Franchise Offering Circular rule is a leap forward for franchisees and a mixed blessing for franchisors.**

In January, though, the commission adopted a major revision to its disclosure rule. 16 C.F.R. Sections 436.1 and those that follow, completing a review process that began in 1995 (60 Fed. Reg. 17656, April 7, 1995).

The new rule modifies the language of the Uniform Franchise Offering Circular, expands and clarifies disclosure requirements and creates categories of franchise transactions for which disclosures are not required. Franchisors must revise and update their disclosure documents, and prospective franchisees can expect to begin receiving disclosures in the new form.

The requirements will take effect July 1 on a voluntary basis. From that date through July 1, 2008, the FTC will allow franchisors to choose between the current and new disclosure requirements. Beginning July 1, 2008, the commission will require franchisors to follow the new rule.

The new rule changes the required contents of franchise-offering circulars. Prospective franchisors now must make disclosures that include the following:

- More information about the franchisor's parent company, including the parent's history and bankruptcies. For a parent company that guarantees franchisor performance, the offering circular must disclose litigation on the parent. The old rule did not require as much disclosure about a franchisor's parent company.
- Litigation that the franchisor has brought against its franchisees. The old rule required disclosure only of litigation brought against the franchisor.
- Fees that a franchisor requires its franchisee to pay to third parties. Previously only fees payable to the franchisor needed to be disclosed.
- In addition to existing requirements to describe the territory a franchisee will receive, the new rule requires disclosure as to whether a franchisor may compete with its franchisees via the Internet or catalog sales, telemarketing or other direct-sales channels, and whether the franchisor pays franchisees for orders that originate within their respective territories.
- More-detailed rules governing franchisor claims about franchisees' historical or potential earnings.
- Details as to what "renewal" means for the particular franchise system. Some franchisors view renewal as extending an existing franchise agreement; others require franchisees to sign agreements with materially different terms.
- Newly formatted data about the franchisor's franchised and company-owned locations. Disclosures now will include information about franchised outlets and company-owned outlets at the beginning and end of a given year.
- As part of already-required disclosures of contact information to help prospective franchisees seek information from current and former franchisees, the circular must disclose if existing franchisees have entered into confidentiality clauses during the past three years that limit their ability to speak freely about their experiences with the franchisor.
- Contact information for franchisee associations that are franchisor-approved or which ask to be identified.
- Franchisor-audited financial statements must be prepared according to generally accepted U.S. accounting principles. That solves an issue under the old rule by making it clear that statements prepared according to Canadian or other non-U.S. accounting standards are unacceptable.

The new rule simplifies the cooling-off period before a franchisor can sign up a franchisee. The old rule said an offering circular had to be provided during the first personal meeting with a prospective franchisee and at least 10 business days before the franchisee signed an agreement or paid any money — but weekends and holidays made it difficult to calculate business days.

The new rule eliminates the first-personal-meeting requirement and sets the time requirement at 14 calendar days. The rule adds that a franchisor must provide an offering circular whenever a prospective franchisee asks for it.

If a franchisor presents a proposed agreement then unilaterally makes a material change, the revised document must be provided to the prospective franchisee at least seven days before signing. In another major change, the new rule allows electronic delivery of documents through the Internet, CD-ROM or computer disk.

The old rule required franchisors to update their offering-circular information within 90 days after the end of their fiscal year. The new rule increases that allowance to 120 days but adds that the circular must be supplemented within a reasonable period after the end of each quarter to reflect material changes.

The new rule also adds exemptions that expand the range and number of franchisors and transactions which do not require compliance. One exemption applies when a franchisee's investment will exceed $1 million; another applies when a franchisee has been in business at least five years and has a net worth of at least $5 million. A third exemption aligns with a provision in California law that applies when a prospective franchisee previously held a specified key position with the franchisor or owned an interest of 25 percent or more in the franchisor. California Corporations Code Section 31106.

The new rule says expressly that it applies only to franchises located in the United States and its territories, eliminating uncertainty under the old rule as to whether U.S. franchisors had to comply when making sales abroad.

Taken as a whole, the new rule is a leap forward for franchisees and a mixed blessing for franchisors. Allowing franchisors to provide disclosures electronically will reduce their preparation, copying and distribution costs, even as they are burdened with the cost of updating their offering circulars to conform to the new requirements.

Franchisees will benefit from the new disclosures. The new rule provides prospective franchisees a better opportunity to evaluate franchises before making what will be, for many, the biggest investments of their lives.

The new rule and supplementary material can be accessed at www.ftc.gov.

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