# Amended Franchise Rule FAQ's

Tags: Franchises, Business Opportunities, and Investments

Related Rules: Franchise Rule

## Amended Franchise Rule
## 16 C.F.R. Part 436

The following questions recently have been asked about the amended Franchise Rule. These questions will be addressed in the forthcoming Compliance Guide. Additional questions and responses will be posted periodically in order to assist franchisors in their review of the amended Rule requirements.

Please note that the opinions expressed below are those of the FTC staff charged with enforcement of the Franchise Rule. They have not been reviewed, approved, or adopted by the Commission, and they are not binding upon the Commission.

## Questions

6. If a franchisor wishes to use the amended Rule on or after July 1, 2007, must it first amend its current UFOC or FTC disclosure document?

7. At times, a franchisor may pay existing franchisees a fee for referring leads to the franchisor. In such circumstances, are the existing franchisees acting as "franchise sellers" under the amended Rule? If so, are such existing franchisees subject to the amended Rule's prohibitions section?

8. Item 19 of the amended Rule deletes the UFOC's express permission to use performance results of substantially similar businesses of affiliates. Was this intentional? Does the amended Rule now prohibit the use of performance claims based upon affiliates?

9. Should "development agents" be treated as subfranchisors because they provide post-sale services to franchisees and, thus, must include financial statements and other information in the disclosure document?

10. What constitutes a "fill-in-the-blank" provision for purposes of the requirement [§ 436.2(b)] that when a franchisor makes unilateral and material changes in the terms and conditions of an agreement, a prospective franchisee must receive the revised agreement at least seven calendar days signing? The Statement of Basis and Purpose indicates that material changes in the terms and conditions of do not include instances where "the only differences between the standard agreements and the completed agreements are 'fill-in-the-blank' provisions, such as the date, name, and address of the franchisee." But might there be other "fill-in-the-blank" provisions that would not necessarily trigger the seven-day waiting period?

    Specifically – with respect to a protected territory – can a franchisor avoid the seven-day waiting period by disclosing a general formula for determining a protected territory in the copy of the standard agreement attached to the disclosure document with a blank to be filled in later for the specific term in the actual franchise agreement that the parties will sign?

    Similarly, could a franchisor avoid the seven-day waiting period by disclosing a range of initial fees, with a blank in the agreement that the parties will sign to be filled in later for the exact fee?

11. Item 21 of the amended Rule permits a new franchisor to issue an unaudited initial balance sheet, so long as that balance sheet is "prepared in accordance with generally accepted accounting principles." What does that mean? In other words, what is the CPA's responsibility to verify the data, and what is the franchisor's responsibility in terms of the data used to prepare the statement?

12. The amended Rule requires franchisors to disclose on the Item 23 receipt page the "name, principal business address, and telephone number of each franchise seller offering the franchise." Who is a "franchise seller" for purposes of this disclosure? If at the time of furnishing the disclosure document a franchisor does not know the particular seller, such as a broker, what should Item 23 of the disclosure document say?

13. May a franchisor use separate charts in Item 17 for different types of franchise agreements?

14. The amended Rule prohibits a franchisor from failing, "upon reasonable request," to furnish a copy of its disclosure document to a prospective franchisee early in the sales process. What happens if a prospective franchisee asks for a copy of the disclosure document at a time when the

franchisor is in the process of preparing its annual update or is awaiting registration in one or more of the registration states? Should the franchisor furnish a document that it knows will soon be updated with more current information?

15. How may a franchisor taking advantage of the amended Rule's disclosure provisions effectively comply with the Item 23 receipt requirement?

16. What is the scope of the "parent" disclosures, as set forth in Items 1, 3, 4, and 21 of the amended Rule?

17. Can financial statements be audited by a Canadian chartered accountant who is unable to state that he or she is an independent certified public accountant? What about other foreign accountants?

18. Does Item 8 of the amended Rule require the disclosure of a *de minimis* ownership interest in a supplier by an officer of the franchisor, and is there a threshold level of ownership that triggers disclosure.

19. Does Item 20 of the amended Rule require franchisors to disclose the names of franchisees that have binding franchise agreements, but have not opened an outlet, and of former franchisees who never opened an outlet?

20. When a franchise broker seeks to induce franchise purchases by independently offering a rebate or similar payment from its own funds, must a franchisor disclose that fact? May such a rebate offer be limited in its duration?

21. May a franchisor require a prospective franchisee to list the statements in the franchisor's disclosure document that he or she regards as material to his or her decision to sign the franchise agreement?

22. If a prospective franchisee has received a UFOC disclosure document prior to July 1, 2008, but has not purchased a franchise by that date, must the franchisor provide the prospective franchisee with its Franchise Disclosure Document ("FDD") 14 calendar days before he or she pays any money or signs a binding agreement in connection with the proposed franchise sale?

23. Must a franchisor identify more than a single individual as a "franchise seller" on its Item 23 receipt, or must a franchisor supplement the receipt page if that is necessary to list every individual with whom a prospective franchisee has significant contacts before the sale is concluded? If any supplementation is required, would it trigger a new 14 calendar day waiting period before a sale may be completed, or may the supplementation be accomplished at the closing of a sale by requiring a purchaser to list all the individual franchise sellers with whom she has had significant contacts?

24. Does a franchisor risk violating section 436.9(e) of the Rule if a prospective franchisee makes a reasonable request for the franchisor's Franchise Disclosure Document ("FDD") earlier in the sales process than required by section 436.2, but at a time when an applicable state franchise investment law prohibits the franchisor from providing its FDD to that prospect until an amendment reflecting a material change has been filed with or made effective by the state?

25. Item 12 requires that a franchisor that does not provide an exclusive territory include a disclaimer underscoring that fact. What constitutes an "exclusive territory" that would permit a franchisor to omit this disclaimer?

26. Does the "insiders" exemption in Section 436.8(a)(6) allow a company that has not yet publicly offered or sold franchises to sell a franchise to a manager with two years of experience with the company without providing that manager with a Franchise Disclosure Document ("FDD")?

27. May a franchisor that makes a financial performance representation in Item 19 include a statement that the franchisor does not make any other financial performance representation and has not authorized its employees or representatives to do so?

28. Section 436.5(t)(5) of the Rule requires disclosure in Item 20 of contact information for former franchisees. It also requires, "in immediate conjunction" with that information, a cautionary notice advising potential purchasers that their contact information may be disclosed if they buy a franchise and later leave the franchise system. May a franchisor disclose this information, including the required notice, in an exhibit or an attachment to its Franchise Disclosure Document ("FDD")?

29. If a new FAQ is issued that would necessitate revision of a franchisor's Franchise Disclosure Document ("FDD"), when must the franchisor revise its FDD?

30. Notwithstanding FAQ 4, if a franchisor's parent is the sole supplier of a good or service without which a franchise cannot be operated, must the financials of the parent be disclosed in Item 21?

31. Section 436.7(a) of the Franchise Rule requires a franchisor to revise its Franchise Disclosure Document ("FDD") within 120 days of the close of its fiscal year, "after which [it] may distribute only the revised document and no other disclosure document." If a franchisor's registration does not expire until after this annual update deadline, may the franchisor continue to use a validly registered FDD in that state after the update deadline, until either: (a) the state completes registration of its updated FDD; or (b) the franchisor's prior registration expires? If so, and if the franchisor uses the same FDD in non-registration states, may it continue to use the FDD in those states as well?

32. Section 436.5(u) of the Rule mandates that the financial statements required in Item 21 "be prepared according to United States generally accepted accounting principles ("GAAP"). May franchisors use financial statements to comply with Item 21 if an auditor issues a qualified opinion because the statements do not comply with FIN 46R issued by the Financial Accounting Standards Board ("FASB")?

33. May a franchisor comply with Section 436.5(s) of the Rule by placing a financial performance representation ("FPR") in an attachment to its Franchise Disclosure Document ("FDD"), rather than in Item 19?

34. Does a general release in a franchise agreement violate the prohibition in Section 436.9(h) of the Franchise Rule against requiring a prospective franchisee to disclaim or waive reliance on representations made in the Franchise Disclosure Document ("FDD")?

35. Is a franchisor required to include in its Franchise Disclosure Document ("FDD") a statement that the financing it offers includes a waiver of a jury trial that will also constitute a waiver of that right in litigation concerning its franchise agreement or other related agreements, if that is the case?

36. Where Item 20 requires disclosures about "company-owned outlets," is that term intended to include not only outlets owned by the franchisor, but also affiliate-owned outlets that are

    "substantially similar" to the outlets offered by the Franchise Disclosure Document ("FDD")?

37. May a franchisor state in Item 12 that it grants an "exclusive territory" if it reserves the right to open franchised or company outlets in so-called "non-traditional venues" like airports, arenas, hospitals, hotels, malls, military installations, national parks, schools, stadiums and theme parks?

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?

## Answers

1. On July 1, 2007, franchisors may start to use the amended Franchise Rule. Does this mean that franchisors can use the amended Rule disclosure format only as of July 1, 2007, or does it mean that franchisors may also apply the non-disclosure provisions (such as timing provisions and prohibitions) of the amended Rule as well? For example, may a franchisor ignore the "first personal meeting" requirement after July 1, 2007, if the franchisor continues to use the UFOC Guidelines format?

   Answer: Since original promulgation of the Franchise Rule, the Commission has always permitted franchisors to comply either by following the provisions of the Franchise Rule itself, or by following the UFOC Guidelines. However, "mix-and-match" disclosures are not permitted: franchisors must use all of one set of requirements or all of the other set. They may not combine elements of the two different formats in a single disclosure document. This same policy will continue in effect on and after July 1, 2007. Franchisors will still have to select one set of disclosure requirement to follow, but they will have three options instead of just two. They can choose to follow ether the original Rule, the UFOC Guidelines, or the amended Rule. Once they make a choice, they must be consistent, following the chosen set of requirements and none other until July 1, 2008, at which time the only format permitted will be the one prescribed in the amended Rule.

   This means that a franchisor that chooses to comply with the original Rule on July 1, 2007, must continue complying with the "first personal meeting" provision, as well as other provisions unique to the original Rule – such as the five business-day contract review provision and separate earnings claims statement – until July 1, 2008.

   Similarly, a franchisor that chooses to use the UFOC format on July 1, 2007, would not have to

Similarly, a franchisor that chooses to use the UFOC format on July 1, 2007, would not have to comply with any of the amended Rule's provisions – for example the amended Rule's integration clause prohibition – until July 1, 2008.

2. On July 1, 2007, may franchisors furnish disclosures electronically even if they elect to use the original Rule or UFOC format?

   Answer: From July 1, 2007, until June 30, 2008, franchisors must select one and only one set of disclosure requirements: original Franchise Rule, amended Franchise Rule, or UFOC Guidelines. Technically, that would preclude a franchisor from furnishing disclosures electronically unless the franchisor opted to use the amended Rule – the only one of the three available sets of disclosure requirements that expressly permits electronic disclosure. Nevertheless, there are strong policy reasons for permitting franchisors to take advantage of technologies that offer the promise of reduced compliance costs, and the FTC staff would not recommend enforcement action against a franchisor that disclosed electronically and was otherwise in total compliance with either the UFOC Guidelines or the original Franchise Rule. This approach ensures that franchise purchasers receive adequate protection and at the same time conforms to the spirit of the Electronic Signatures in Global and National Commerce Act ("E-SIGN"), 15 U.S.C. 7001. Moreover, electronic disclosure is a method of delivery; it does not affect substantive disclosure requirements. Accordingly, for FTC purposes, all franchisors can begin using electronic disclosure on July 1, 2007. Of course, any franchisor electing to furnish disclosures electronically must follow the provisions for doing so set forth in the amended Rule.

3. Does the new large investment exemption apply to entities?

   Answer: The large investment exemption focuses on individuals and level of their investment, based on the rationale that a prospective investor able to invest at least $1 million (minus franchisor financing and the cost of unimproved land) is likely to be sophisticated and able to make an investment decision without federal government intervention. As noted in the Statement of Basis and Purpose, that rationale does not pertain when individuals, each investing only a small amount, combine in a group. Merely aggregating the small investments of a group of individuals does not transform the individuals into sophisticated investors. For that reason, the amended Rule requires that at least one individual in an investor group contribute at the $1 million threshold. The same analysis applies in the case of individual owners of an entity. In order to ensure that such owners are sophisticated, at least one individual owner must contribute at the $1 million threshold.

   The large investment exception, however, does not address how a qualifying individual may organize its business. Nothing in the amended Rule would preclude a qualifying individual contributing $1 million – and thus exempt from the amended Rule – from forming a partnership, corporation, or joining with a corporation or other entity, to operate the franchised outlet after signing the franchise agreement.

4. Must a franchisor include in its disclosure document the financials of its parent when the parent only sells goods or services to franchisees?

   Answer: The amended Rule requires separate financials for any "parent that commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations." Thus, this

requirement would apply when the franchisor has an obligation to provide goods or services to franchisees, and that obligation is guaranteed or assumed by the franchisor's parent. If a parent happens to supply goods or services to franchisees where there is no underlying obligation on the part of the franchisor to supply them, then the parent is no different from any other third-party supplier and its financials need not be disclosed. On the other hand, if a franchisor is obligated to provide goods and services and the parent assumes that responsibility, or the franchisor arranges

for the parent to provide goods and services directly to franchisees on its behalf, then the parent's financials must be disclosed.

5. Item 3 of the amended Rule states that a franchisor must state it was "a party to any material civil action involving the franchise relationship in the last fiscal year." At the same time, the Statement of Basis and Purpose for the amended Rule says that this disclosure of franchisor-initiated litigation covers only suits filed in the last fiscal year and needs to be updated only annually. Is the disclosure cumulative – that is, does the franchisor have to disclose any suit to which it is a party that was ongoing in the last fiscal year?

   Answer: The franchisor-initiated litigation disclosure is intended to capture suits that were *filed* by the franchisor in the last fiscal year. In that regard, "party to a material civil action . . . in the last fiscal year" means "party to *any new* material civil action filed in the last fiscal year." This disclosure, therefore, is not cumulative: pending suits *filed* by the franchisor against a franchisee more than a fiscal year ago need not be included.

   Accordingly, when preparing an annual update, the franchisor must disclose the suits it has filed against franchisees in the last fiscal year only (e.g., 2006 suits). Those suits must remain in the disclosure document used for the new fiscal year (e.g. 2007 disclosure document). No quarterly updating is required. Franchisors that initiate suits in the middle of a fiscal year or companies new to franchising can wait until their next annual update (e.g., 2008) to reference these new suits. At the beginning of each new fiscal year (e.g., 2008), the franchisor should delete the list of previously disclosed suits (e.g., 2006 suits) and substitute it with any new franchisor-initiated litigation filed in the most recently concluded fiscal year (e.g., 2007 suits).

6. If a franchisor wishes to use the amended Rule on or after July 1, 2007, must it first amend its current UFOC or FTC disclosure document?

   Answer: On or after July 1, 2007, franchisors may start using the amended Franchise Rule. By July 1, 2008, all franchisors must use the amended Rule format only. It is entirely at the discretion of each individual franchise system to decide when during the course of the phase-in period to make the conversion to the amended Rule format.

   Most likely, many franchisors will start using the amended Rule when they prepare their annual update. For example, we expect that many franchisors with a calendar-year fiscal year will start using the amended Rule in March or April of 2008, when preparing their annual update for 2008.

   Under the amended Rule, a franchisor need not amend its disclosure document immediately in order to start using the amended Rule. For example, a franchisor with a calendar-year fiscal year may decide on July 1, 2007, that it will start using the amended Rule format on September 1, 2007, which falls within the third quarter of the franchisor's fiscal year. The amended Rule requires franchisors to revise their disclosure document only quarterly. Accordingly, the franchisor need

franchisors to revise their disclosure document only quarterly. Accordingly, the franchisor need not revise its current disclosure document until the time for preparing a quarterly update, which, in the example, would fall in October, 2007.

Nonetheless, if the franchisor continues to sell franchises, it must furnish a quarterly update for the third quarter that contains all of the required disclosures set forth in the amended Rule. For

example, the quarterly update must include the amended Rule's more detailed Item 20 information. For that reason, franchisors, as a practical matter, may wish to amend their disclosure documents when they start using the amended Rule – even if they do so during a fiscal quarter – rather than preparing detail quarterly updates until their next annual update.

Regardless of when it starts to update its disclosures, the franchisor in the example above must begin to comply with the amended Rule's timing provisions and prohibitions on September 1, 2007. For example, even if the franchisor decides to update its disclosures through a quarterly update, it must immediately start on September 1, 2007, complying with the amended Rule's non-disclosure provisions, such as timing provisions (e.g., disclosure earlier in the sales process upon reasonable request) and prohibitions (e.g., prohibition against inclusion of disclaimers or waivers).

7. At times, a franchisor may pay existing franchisees a fee for referring leads to the franchisor. In such circumstances, are the existing franchisees acting as "franchise sellers" under the amended Rule? If so, are such existing franchisees subject to the amended Rule's prohibitions section?

   Answer: Merely accepting compensation for referring leads to a franchisor, without more, is not enough to bring an existing franchisee within the amended Rule's definition of "franchise seller" and, therefore, does not subject the franchisee to the amended Rule's prohibitions.

   This issue arises under the amended Rule's definition of "franchise seller," which includes brokers. The Statement of Basis and Purpose to the amended Rule states that a "broker" is a person who: "(1) is under contract with the franchisor relating to the sale of franchises; (2) receives compensation from the franchisor related to the sale of franchises; and (3) arranges franchise sales by assisting prospective franchisees in the sales process." At the same time, the Statement of Basis and Purpose states that the term "broker" is sufficiently narrow to exclude existing franchisees who may refer potential franchisees to the franchisor because such individuals are not "under contract with the franchisor to sell franchises." 72 Fed. Reg. 15,462 n. 169 (Mar. 30, 2007).

8. Item 19 of the amended Rule deletes the UFOC's express permission to use performance results of substantially similar businesses of affiliates. Was this intentional? Does the amended Rule now prohibit the use of performance claims based upon affiliates?

   Answer: All financial performance representations must have a "reasonable basis." When a franchisor has adequate performance data of its own upon which to base a performance representation, basing a financial performance representation on affiliate information likely would not be "reasonable." Nevertheless, in limited circumstances, a franchisor may base a financial performance claim upon the results of operations of the substantially similar business of an affiliate.

The question posed above refers to the following statement in the UFOC Guidelines' instructions for Item 19:

> "In the absence of an adequate operating experience of its own, a franchisor may base an earnings claim upon the results of operations of a substantially similar business of a person affiliated with the franchisor or franchisees or that person; provided that disclosure is made of any material differences in the economic or market conditions known to, or reasonably ascertainable by, the franchisor."

The amended Rule does not incorporate this specific language; nevertheless, consistent with the UFOC Guidelines, the amended Rule does allow franchisors to use affiliate information as a basis for a performance claim in certain narrow circumstances – specifically, when the franchisor lacks an adequate operating experience of its own. However, as in the case of using any financial performance representation based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of such outlets that may differ materially from the outlets being offered for sale.

9. Should "development agents" be treated as subfranchisors because they provide post-sale services to franchisees and, thus, must include financial statements and other information in the disclosure document?

Answer: No. Even if a person performs post-sale on behalf of a franchisor, that person or entity is not a "subfranchisor" under the amended Rule *unless* that person is a party to the franchise agreement (or to another agreement involved in the franchise). This is true regardless of the name given to the person, be it "development agent," "area developer," or "regional developer."

Staff's determination as to whether a "development agent" should be considered a "subfranchisor" begins with consideration of how the amended Rule treats the term "subfranchisor." The amended Rule delineates the term "subfranchisor" within the definition of the term "franchisor," as follows:

> *Franchisor* means any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors. For

purposes of this definition, a "subfranchisor" means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance.

Thus, a "subfranchisor" is a person "who functions as a franchisor," by use of the qualifying phrases "grants a franchise" and "participates in the franchise relationship," the amended Rule clarifies that in order to be considered a subfranchisor, a party must have – as a franchisor has – (1) the authority to enter into a franchise agreement (or another agreement relating to the franchise), and (2) as a result of entering into such an agreement, that party is obligated to perform after the purchase of the franchise is consummated.

The role of a subfranchisor is materially different from that of a broker, for example, because a broker typically is not a party to the franchise agreement and does not have post-sale contractual obligations to franchisees. In this regard, the amended Rule's Statement of Basis and Purpose, in the discussion of Item 21 regarding subfranchisor financial information, states that "the term 'subfranchisor' is limited in the Rule to circumstances where the subfranchisor steps into the shoes of the franchisor by selling [franchises] and performing post-sale obligations. It does not reach those individuals who may be called 'subfranchisors,' but who act like brokers, having no post-sale commitments to franchisees." 72 Fed. Reg. 15,511 (Mar. 30, 2007).

10. What constitutes a "fill-in-the-blank" provision for purposes of the requirement [§ 436.2(b)] that when a franchisor makes unilateral and material changes in the terms and conditions of an agreement, a prospective franchisee must receive the revised agreement at least seven calendar days signing? The Statement of Basis and Purpose indicates that material changes in the terms and conditions of do not include instances where "the only differences between the standard agreements and the completed agreements are 'fill-in-the-blank' provisions, such as the date, name, and address of the franchisee." But might there be other "fill-in-the-blank" provisions that would not necessarily trigger the seven-day waiting period?

    Specifically – with respect to a protected territory – can a franchisor avoid the seven-day waiting period by disclosing a general formula for determining a protected territory in the copy of the standard agreement attached to the disclosure document with a blank to be filled in later for the specific term in the actual franchise agreement that the parties will sign?

    Similarly, could a franchisor avoid the seven-day waiting period by disclosing a range of initial fees, with a blank in the agreement that the parties will sign to be filled in later for the exact fee?

    Answer: In the Statement of Basis and Purpose, the Commission made clear that it will interpret "fill-in-the-blank" provisions narrowly. "To the extent that substantive contractual details – such as geographic area of a protected territory and interest rates – are not disclosed in the basic disclosure document or its attachments, then the completed document must be disclosed seven calendar days before signing." 72 Fed. Reg. 15471 n.277 (Mar. 30, 2007). The seven-day waiting period ensures that, before entering into any franchise agreement or paying any related fee, a

prospective franchisee can review and understand all material terms and conditions of the franchise arrangement. Accordingly, where the franchisor includes in the franchise agreement material terms that previously have not been disclosed or unilaterally changes material terms that previously have been disclosed, then the amended Rule requires that the prospective franchisee have at least seven calendar days to review the proposed revised agreement. This does not extend to non-substantive, fill-in-the-blank provisions.

Substantive terms of a franchise arrangement – such as fees, interest rate, and the parameters of a protected territory – must be disclosed in the agreement attached to the basic disclosure document or the franchisor must afford the prospect seven days to review the terms before signing or paying a fee. Of course, if the parties are negotiating such terms at the initiation of the prospect, then no additional waiting period is required.

On the other hand, with respect to protected territories, a franchisor may fill in a term in a franchise agreement without triggering the seven-day review period, provided the territory previously has been identified, but the exact name or circumstance was unknown at the time of disclosure. For example, if it is a franchisor's practice to grant protected territories on a county-wide basis, the franchisor may include a statement in its disclosure document to the effect that: "We assign protected territories by county. Your protected territory will be [name of county], in [state]." This sufficiently details the scope of the protected territory – an entire county – to enable the prospect to apply the statement to his or her specific proposed outlet without any further explanation. In the opinion of FTC staff, filling in the exact name of the county at a later date would not necessarily constitute a substantive change. Nevertheless, a vague description of a protected territory – such as a statement that the protected territory will range from 1 to 10 miles from the prospective franchisee's outlet – is insufficiently detailed to give a prospective franchisee notice of the likely scope of his or her territory; filling in the exact number of miles at a later date, therefore, would be a substantive modification of the franchise agreement triggering the seven-day waiting period.

11. Item 21 of the amended Rule permits a new franchisor to issue an unaudited initial balance sheet, so long as that balance sheet is "prepared in accordance with generally accepted accounting principles." What does that mean? In other words, what is the CPA's responsibility to verify the data, and what is the franchisor's responsibility in terms of the data used to prepare the statement?

Answer: While Item 21 permits start-up franchisors that do not already have audited financial statements to phase-in audited financial statements, it nonetheless states that franchisors must prepare audited financial statements as soon as practicable, and it instructs that an unaudited statement must be prepared "in a format that conforms as closely as possible to audited statements." In the Statement of Basis and Purpose for the amended Rule, the Commission stated that an audit is not required for start-up franchisors, but financial statements nonetheless must conform to generally accepted accounting principles ("GAAP"). There is no requirement in the amended Rule that the opening balance sheet be prepared by an accountant, and it may well be the case that many start-up franchisors will not employ an accountant to prepare such balance sheets. While franchisors have flexibility in preparing such statements, in the opinion of FTC staff, a franchisor's management would be expected to look to GAAP for guidance. For example, staff would expect an opening balance sheet to be in the format of a typical balance sheet prepared under GAAP and to include explanatory notes, where warranted, to ensure that the balance sheet

is clear and accurate. In short, balance sheets must be in a format that conforms as closely as possible to audited statements prepared under GAAP. Further, to avoid any confusion with an audited balance sheet, the franchisor must clearly and conspicuously note that the balance sheet is unaudited.

12. The amended Rule requires franchisors to disclose on the Item 23 receipt page the "name, principal business address, and telephone number of each franchise seller offering the franchise." Who is a "franchise seller" for purposes of this disclosure? If at the time of furnishing the disclosure document a franchisor does not know the particular seller, such as a broker, what should Item 23 of the disclosure document say?

    Answer: A "franchise seller," under the amended Rule is "a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities." As stated in the Statement of Basis and Purpose for the amended Rule, this disclosure provides prospective franchisees with contact information for any seller with whom they are dealing and is "also helpful for law enforcement purposes, identifying who may be responsible for furnishing the disclosures."[1]

    When preparing the receipt page, franchisors should identify and include contact information for those particular sellers "offering the franchise." That means those persons who have significant contacts with the prospective franchisee – for example, individuals assisting specific prospective franchisees in completing the application and other forms, or engaging in ongoing conversations with the specific prospective franchisees throughout the sales process. FTC staff believes, in particular, that any person who receives a sales commission and/or quota credit if the deal is consummated are the type of "franchise seller" who must be listed on the receipt.

    The Statement of Basis and Purpose makes clear that this disclosure requirement is not intended to replicate Item 2 of the current UFOC Guidelines – that is, franchisors should not include a generalized list of all subfranchisors, brokers, or other individuals that may be involved in the sales process, but who do not have contacts with the individual prospective franchisee who will sign the receipt page[2]. Nevertheless, FTC staff recognizes that the identity of a franchise seller may not be known at the time the franchisor furnishes the disclosure document. This is particular true if, under the amended Rule, the prospective franchisee takes advantage of the right to obtain a copy of the disclosure document early in the sales process.

    A franchisor need not create an individualized disclosure document for each franchise sale. It is the FTC staff's view that if, at the time of furnishing the disclosure document, a franchisor does not know the particular seller, such as a broker, the franchisor has several options. First, a franchisor could include an instruction in the receipt page that the prospective franchisee write in the name of the franchise seller before signing and returning the receipt page to the franchisor. Second, the franchisor could: (1) attach to the previously signed receipt a statement, business card, or other document showing the name of the seller; and (2) send a copy of the attachment to the prospective franchisee so that the prospective franchisee has a copy of the completed receipt. At that point, both the franchisor and prospective franchisee will each have a copy of the same receipt. In short, in the FTC staff's view, the absence of an identifiable seller at the time of

disclosure should not force a delay in the prospective franchisee's ability to sign the receipt page, provided that the receipt page is updated once the identity of the seller is known.

Finally, FTC staff notes that the amended Rule's instructions require franchisors to retain for each completed franchise sale "a copy of the signed receipt for at least three years." Staff expects that copies of signed receipts will include the required contact information for sellers, either because

such contact information was filled in before the franchisor furnishes disclosures or was attached to the receipt once such contact information was known after the prospective franchisee signed the receipt.

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[1] 72 Fed. Reg. 15445, 15513 (Mar. 30, 2007)

[2] *Id.*

13. May a franchisor use separate charts in Item 17 for different types of franchise agreements?

    Answer: Yes. A franchisor always can use separate charts for different agreements (e.g., subfranchisor agreements), whether those be in Item 17, Item 20, or other disclosure items.

    As noted in the Statement of Basis and Purpose, the amended Rule should be applied in a manner that is consistent with historic practices. For instance, with respect to this particular issue, the NASAA commentary on Item 20 specifically states that franchisors should use separate charts for statistics reflecting a subfranchisor's region and for statistics reflecting national data for the franchise being offered. The use of separate charts for different agreements fosters precision and clarity, consistent with the goal of full and accurate disclosure.

14. The amended Rule prohibits a franchisor from failing, "upon reasonable request," to furnish a copy of its disclosure document to a prospective franchisee early in the sales process. What happens if a prospective franchisee asks for a copy of the disclosure document at a time when the franchisor is in the process of preparing its annual update or is awaiting registration in one or more of the registration states? Should the franchisor furnish a document that it knows will soon be updated with more current information?

    Answer: [Note: See also FAQ 24] If a request for disclosures comes at a point in time when a franchisor is not obliged by section 436.7 to have just finished updating its disclosures, the franchisor may provide the then-current version of the disclosures, even if the disclosures will change with the next required update. For example, if the franchisor is in the middle of its fiscal quarter or is in the middle of the 120-day period after the close of its fiscal year for preparing an annual update, it may continue to provide prospects with its most current document. In order to avoid any possible misrepresentations, however, the "best practices" would be for the franchisor to inform the prospect that it is preparing revised disclosures and to make such revised disclosures available to the prospective franchisee when issued or registered. At the very least, however, the franchisor must provide copies of its updates to a prospect, upon reasonable request, before the prospect signs the franchise agreement.

    The amended Rule, like the original Rule, provides specific times when a franchisor must furnish

its disclosure documents. It also specifies when a franchisor must update its disclosures. But the amended Rule does not require a franchisor to update its disclosures continuously or immediately upon every new occurrence, or to stop selling until it has updated its disclosures. Accordingly, the franchisor may give out its then-current disclosure document pursuant to either the amended Rule's 14 calendar-day disclosure requirement [§ 436.2(a)], or the amended Rule's requirement to provide the disclosure document "earlier in the sales process than required under § 436.2 of this part, upon reasonable request." Nevertheless, in the latter instance, prospects who request and receive the disclosure document early in the sales process may not, when they are about to sign the franchise agreement, have the benefit of the most current information. Therefore, the Commission included § 436.9(f) in the amended Rule, which forbids a franchisor from failing to furnish a copy of its most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisee signs a franchise agreement.

15. How may a franchisor taking advantage of the amended Rule's disclosure provisions effectively comply with the Item 23 receipt requirement?

Answer: The amended Rule permits franchisors flexibility in complying with the Item 23 receipt requirements. Below is the staff of the Commission's view on three possible alternatives posed by practitioners.

A. Use of link to external receipt webpage

Section 436.6(d) of the amended Franchise Rule prohibits franchisors from including in any electronic disclosure document external links to materials outside of the disclosure document itself. The first requester proposes an exception to this prohibition for the limited purpose of facilitating compliance with the amended Rule's Item 23 receipt requirement. Specifically, he proposes that franchisors be permitted to place an icon (such as a "submit" or "submit receipt" button) on the Item 23 receipt page that links it to an external receipt webpage where the prospective franchisee could acknowledge receipt of the document. According to this proposal:

For the following reasons, FTC staff believes the proposed limited use of an external link to a web-based receipt page, as described above, is permitted under the amended Rule, because it is consistent with the goal of permitting electronic disclosure and does not diminish the level of protection the amended Rule provides to prospective franchisees.

As noted above, the amended Rule prohibits the use of external links. This prohibition is necessary to preserve the integrity of a disclosure document. Without this prohibition, nothing would prevent a franchisor from including external links to materials that are either false or deceptive, that contradict the franchisor's authorized disclosures, or that are not required or permitted by either federal or state franchise disclosure laws. Nevertheless, § 436.6(d) of the amended rule does allow inclusion of scroll bars, internal links, and search features "for the sole purpose of enhancing the prospective franchisee's ability to maneuver through an electronic version of a disclosure document."

As proposed in the requester's letter, the external link to a webpage accessible only to recipients of a disclosure document would facilitate compliance with the Item 23 receipt requirement. The

proposed webpage would be identical to the Item 23 receipt page, with the addition of instructions for submitting the receipt. This is consistent with amended Rule Item 23, which permits franchisors to include instructions for submitting the receipt in the receipt page itself. Finally, this proposal ensures that no other links or materials will be accessible from the webpage, thereby preventing access to materials that may be deceptive or false, contradictory, or not required or permitted in a disclosure document by federal or state law. Accordingly, in the opinion

of FTC staff, it would not violate the amended Rule for a franchisor to include a link in the receipt page to a webpage that facilitates submission of the Item 23 receipt provided that: (1) the web-based receipt page is accessible only by prospective franchisees from Item 23 of an electronic disclosure document; and (2) no other content or external links are included in the web-based receipt other than information required or permitted by Item 23 of the amended Rule (i.e., instructions for submitting the receipt).

B. Icon enabling prospective franchisees to print receipt page

A second requester suggests that franchisors be permitted to include an icon on the electronic receipt page, that, when pressed, would enable the prospect to print out a copy of just the receipt, which could then be signed and mailed or faxed to the franchisor. This would facilitate compliance with the Item 23 receipt requirement by enabling prospects to print out the receipt without printing out the entire disclosure document. In the opinion of FTC staff, this is an acceptable method of ensuring compliance with the amended Rule's receipt page requirement.

C. Separate receipt page attachment

Finally, a third requester suggests that franchisors be permitted to email a prospect two documents: (1) the basic disclosure document; and (2) a separate receipt page that could be printed out, signed, and returned to the franchisor. In FTC staff's opinion, this would not be an acceptable method of complying with the Item 23 receipt page requirement because, it would be possible for a prospect to open nothing but the separate receipt page. In such an instance, there would be no proof that the prospect, in fact, was able to open and had the opportunity to review the disclosure document itself. The scenario proposed by the third requester could easily be modified, however, using one of the two methods posited by the other two requesters that are discussed above – inserting a link to a separate web-based receipt page in the text of the Item 23 receipt itself, or including an icon in the Item 23 receipt that enables a prospect to print out just the receipt page. Either of these two approaches would ensure that each prospect submitting a receipt had, in fact, opened the electronic disclosure document.

- The external receipt webpage would be accessible only from a link in either of the two receipt pages that are included within the electronic disclosure document;

- The external receipt webpage would include only an online form to be completed for the purpose of acknowledging receipt of the disclosure document. The content of the online form would be identical to that required under Item 23 of the amended Rule, adapted only to accommodate the online process (such as including instructions necessary for completing and submitting the form); and

- The external receipt webpage would contain no additional content or secondary links.

16. What is the scope of the "parent" disclosures, as set forth in Items 1, 3, 4, and 21 of the amended Rule?

Answer: The scope of the "parent" disclosures in the amended Rule varies depending upon the specific disclosure items. Below, FTC staff addresses specific questions that have been raised regarding the parent disclosures found in Items 1, 3, 4, and 21 of the amended Rule. As an initial

matter, the original Franchise Rule, unlike the Uniform Franchise Offering Circular ("UFOC") Guidelines, always has required the disclosure of parent information, even though the states do not require the disclosure of such information. Accordingly, in large measure, the amended Franchise Rule retains these provisions from the original Rule, with some modifications, as discussed below.

Before addressing the specific parent disclosures set forth in the amended Rule, FTC staff notes the definition of "parent" set out at section 436.1(m): "an entity that controls another entity directly, or indirectly through one or more subsidiaries." The definition focuses on "control," not mere ownership. Accordingly, a parent that merely owns, but does not control, a franchise system – for example, the parent does not shape the franchisor's policies or control franchise sales or operations – is not a "parent" for purposes of any disclosure item.

A. Item 1: Identity of any parents

One question is whether the term "parent" in Item 1 is intended to be interpreted narrowly to cover only the "ultimate parent that controls all the subsidiaries." Item 1 requires franchisors to disclose "[t]he name and principal business address of any parents." The use of the word "parents" is intentional, anticipating that a franchisor may be required to disclose one or more parents, provided that such parents control the franchisor. This issue is addressed in the SBP.[1]There, the Commission made clear that a franchisor must disclose all parents, including intermediate parents, specifically rejecting the suggestion that only the ultimate parent be disclosed.[2]

This does not mean that a franchisor must disclose all parent-entities in the chain of ownership of the franchisor. Rather, the franchisor must disclose only those parents that in fact exercise control over the policies and direction of the franchise system, consistent with the definition of parent, as mentioned above. As the Commission noted in the Statement of Basis and Purpose ("SBP"), the disclosure of parents – meaning those entities that control the franchise system – is necessary to "ensure that a prospective franchisee understands who may control or influence the franchisor's operations." [3] For many franchise systems, this may mean the "ultimate parent," but such determinations can be made only on a case-by-case basis depending upon the particular facts.

B. Item 3: Litigation

Another question asks about the scope of the obligation to disclose parent litigation. Preliminarily, FTC staff notes that Item 3 specifies that litigation of a parent is required only if the parent "induces franchise sales by promising to back the franchisor financially or otherwise guarantees the franchisor's performance." Specifically asked is what difference, if any, exists between "financial backing," on the one hand, and "guaranteeing performance," on the other.

"Financial backing" here is intended to refer to promises that a parent may make to ensure that

the franchise system is and remains on stable financial footing. Typically, this would mean that the parent promises to infuse the franchisor with cash or other assets or to extend credit, if needed, or to pay debts to third parties on behalf of the franchisor. In such a case, the franchisor or its parent induces franchise sales by representing that the purchase of a franchise is a safe investment because the parent will directly or indirectly pay third-party debts – thereby keeping the franchise system financially stable – if the franchisor cannot make such payments itself.

On the other hand, "guaranteeing performance" refers to promises made between the franchisor's parent and the franchisor for the benefit of franchisees or from the franchisor's parent directly to franchisees. Typically, this means that the parent promises to perform obligations to franchisees that the franchisor has undertaken in its franchise agreement, if the franchisor is unable to do so. In such a case, the parent induces franchise sales by promising to fulfill the franchisor's obligations to franchisees, if the franchisor cannot perform such obligations itself.

C. Item 4: Bankruptcy

Another question asks whether the use of singular term "parent" in the Item 4 bankruptcy disclosures is meant to be distinct from the plural term "parents" in Item 1. Specifically asked is whether, for Item 4 purposes, it is sufficient to disclose only the ultimate parent's prior bankruptcy, or must intermediate parents be disclosed as well.

The disclosure of parent information in Item 4 is intended to be consistent with that of Item 1. If any of the parents listed in Item 1 have had a bankruptcy in the relevant time period, then that information must be disclosed in Item 4. Indeed, in the SBP, the Commission specifically rejected comments suggesting that parent bankruptcy disclosures are unwarranted, finding that parent information is material. The Commission noted, for example, that when a parent is in bankruptcy its assets include any franchisor-subsidiary. "Under such circumstances, a prospective franchisee should be made aware that the franchisor in which it is considering investing might be sold, possibly to a competitor or to a company lacking prior franchise experience."[4]

D. Item 21: Financial statements

Item 21 requires the disclosure of parent financials if the parent "commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations." A question posed is whether the phrase "post-sale obligations for the franchisor" is intended to capture only those obligations that benefit franchisees, noting that a parent may agree to perform "back office services for the franchisor's own internal purposes." [5] In the opinion of FTC staff, the disclosure of parent financial information is required only when the franchisor's parent commits to perform post-sale obligations for the direct benefit of franchisees. Agreements between a franchisor and its parent for administrative and other services for the franchisor's internal purposes do not trigger the parent financial disclosure requirement.[6]

Another question is whether the requirement that a parent disclose its financials is triggered by *any* commitment to perform on behalf of the franchisor or whether the requirement is triggered only if the parent commits to perform something more, such as committing to perform substantial post-sale obligations or a preponderance of the post-sale obligations that have to be provided to the franchisee.

As noted above, the amended Rule requires parent financial statements where the parent commits to perform or guarantees the franchisor's obligations. FTC staff believes that the use of the plural "obligations" was intended to convey that the performance of a single or isolated obligation alone is insufficient to trigger the parent financials disclosure. At the same time, Item 21 sets forth no specific threshold standard, such as "substantial obligations," or "preponderance of obligations."

Accordingly, FTC staff would expect a parent to disclose its financials if it commits or guarantees to perform more than an isolated obligation to franchisees on behalf of the franchisor.

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[1] 72 Fed. Reg. 15445, 15475 (Mar. 30, 2007).

[2] *Id.* n.317. Only the identify of the parent(s) need be disclosed in Item 1. As discussed in the SBP, "[i]n contrast with the Item 1 disclosures for affiliates and predecessors, a franchisor need not disclose, for example, the parent's business background, length of time selling franchises or engaging in other lines of business."

[3] *Id.*

[4] 72 Fed. Reg. at 15484.

[5] An additional question is whether Item 21 requires the disclosure of an affiliate's financials, if the affiliate commits to perform post-sale obligations for the franchisor. The amended Rule makes clear that the disclosure of an affiliate's financials is voluntary, if the affiliate "absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement." 16 C.F.R. § 436.5(u)(1)(iii). Accordingly, an affiliate need not disclose financials unless it qualifies as a "parent" and commits to perform or guarantees the franchisor's post-sale obligations.

[6] A related question is whether the parent financials disclosure would be triggered if a parent's employees perform services on behalf of a franchisor. Arguably, such services are akin to providing back office support for the franchisor. In other words, is the Item 21 parent financials disclosure obligation limited to where the parent commits to perform obligations directly for the benefit of franchisees under the name of the parent company – meaning that franchisees are specifically looking to the parent company to provide those services (and not simply because an employee of the parent working for the franchisor provides some service for the franchisee)? In the opinion of FTC staff, the Item 21 parent financials disclosure is intended to cover formal arrangements between the parent and franchisor for the benefit of franchisees or formal arrangements directly between the parent and franchisees. The performance of post-sale obligations by a parent's employee for the benefit of franchisees does not trigger the Item 21 parent financial disclosures, absent a formal commitment or guarantee on the part of the parent to perform.

17. Can financial statements be audited by a Canadian chartered accountant who is unable to state that he or she is an independent certified public accountant? What about other foreign accountants?

Answer: In the view of FTC staff, a Canadian or other foreign accountant or accounting firm may audit financial statements for Franchise Rule purposes if the accountant or accounting firm (1) is registered with the Public Company Accounting Oversight Board ("PCAOB"); and (2) recently audited one or more financial statements that have been filed with and accepted by the SEC.

Discussion: The question arises from Section 436.5(u) of the amended Franchise Rule (Item 21), which provides that each disclosure document required under the Rule must contain financial statements prepared "according to United States generally accepted accounting principles (GAAP), as revised by any future United States government mandated accounting principles, or as permitted by the Securities and Exchange Commission (SEC)." Further, these financial statements (with a limited exception for those start-up franchisors phasing-in financial statements) "must be audited by an independent certified public accountant (CPA) using generally accepted United States auditing standards (GAAS)." [1]

FTC staff do not interpret use of the term "CPA" in the Franchise Rule as permitting only an American CPA to audit financial statements. In staff's view, the Franchise Rule uses the term "CPA" because typically in the offer of franchises in the United States it is a CPA that audits financial statements. The additional language regarding "generally accepted accounting principles (GAAP), as revised by any future United States government mandated accounting principles, or as permitted by the Securities and Exchange Commission (SEC)," argues for a more expansive interpretation than one that would narrowly allow only an American CPA to audit financial statements.

As indicated in the Rule language quoted above, in considering whether foreign accountants may audit financial statements for Franchise Rule purposes, FTC staff look to comparable federal policies regarding public companies in the securities area. In this regard, the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board ("PCAOB"), which, among other things, is charged with setting forth and monitoring auditing standards. Section 102 of that Act prohibits accounting firms that are not registered with the PCAOB from preparing or issuing audit reports on U.S. public companies and from participating in such audits. Further, section 106(a) of the Act provides that any non-U.S. public accounting firm that prepares or furnishes an audit report with respect to any U.S. public company is subject to the Board's rules to the same extent as a U.S. public accounting firm. Therefore, in accordance with Sarbanes-Oxley, FTC staff believe that, at the very least, any foreign accounting firm seeking to audit financial statements for purposes of the Franchise Rule must register with the PCAOB.

Foreign PCAOB registered accountants are subject to the same auditing standards as American PCAOB registered accountants. Under SEC rules, financial statements must be prepared using GAAP (or in accordance with another comprehensive basis of accounting standards, with an audited reconciliation to U.S. GAAP). [2] In addition, foreign auditors, like their American counterparts, must satisfy independence requirements.[3] Foreign accountants are also subject to enforcement actions for any violation of federal securities laws.

In addition to satisfying PCAOB registration requirements and SEC accounting and auditing standards for public companies, foreign accountants wishing to audit financial statements under the Franchise Rule must meet any additional qualifications imposed by the SEC. This includes a

review of the foreign accountant's quality controls, personnel qualifications, knowledge of professional standards, and recent audit performance. This review is typically conducted by a consultant retained by the foreign accounting firm. The foreign accountant must have all filings with the SEC that contain its audit report reviewed by an American or foreign accountant knowledgeable with respect to U.S. GAAP, PCAOB standards and requirements, and SEC rules and regulations. Currently, that means that the reviewing accounting firm must determine, among other things, that the filings have been be prepared using U.S. GAAP and audits have been prepared using U.S. GAAS. [4]The reviewing accounting firm, however, reviews the filing only and need not perform a complete audit on the reviewed material.

Applying these principles, Commission staff believes that foreign accountants or accounting firms may audit financial statements for Franchise Rule purposes consistent with PCAOB and SEC policies. That means that all foreign accounting firms wishing to prepare audited financials under the Franchise Rule must: (1) be registered with PCAOB; and (2) recently audited one or more financial statements that have been filed and accepted by the SEC.

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[1] The Commission staff will look to SEC rules and policies when determining what constitutes "U.S. GAAS."

[2] 17 C.F.R. § 210.2-02(b).

[3] 17 C.F.R. § 210.2-01.

[4] Commission staff recognizes that SEC rules and policies may change with respect to what constitutes generally accepted auditing standards. We intend to interpret the Franchise Rule's accounting, as well as auditing standards, consistent with SEC practice.

18. Does Item 8 of the amended Rule require the disclosure of a de minimis ownership interest in a supplier by an officer of the franchisor, and is there a threshold level of ownership that triggers disclosure.

Answer: A *de minimis* ownership interest that would not be "material" to an investment decision by a prospective franchisee need not be disclosed in Item 8. 16 C.F.R. § 436.5(h)(3); see 72 FR 15444, 15487-88 & n.451 (Mar. 30, 2007). The question of whether an officer's interest in a supplier is "material," however, is a factual one that necessarily requires consideration of all the facts and circumstances, and cannot be answered in the abstract. Consequently, there can be no fixed "threshold" level of ownership that would uniformly provide a safe harbor for officers with a financial interest below a specified level.

Generally, it can be said that the more direct an officer's ownership interest is in a supplier, such as ownership of a controlling interest in the supplier's stock, the more likely it is that staff would deem the ownership interest to be material. Conversely, the more indirect and attenuated the ownership interest, the less likely it is that the interest would be deemed material. Thus, for example, if an officer of a franchisor owns shares of a diversified mutual fund that does not have a stated policy of concentrating its investments in a particular industry or line of business, the fact that the fund may acquire and hold stock in a supplier would not trigger the disclosure

requirement.

It is worth emphasizing that the requirement does not demand disclosure of the identity of the officer with the ownership interest, or even the extent of the interest. It only requires the identification of "any supplier" from which franchisees are required to make a purchase in which

an officer of the franchisor owns "an interest." Franchisors therefore would be well advised, in assessing the materiality of an officer's interest, to err on the side of disclosure.

19. Does Item 20 of the amended Rule require franchisors to disclose the names of franchisees that have binding franchise agreements, but have not opened an outlet, and of former franchisees who never opened an outlet?

Answer: Yes. Item 20 requires franchisors to: "[d]isclose the names of *all current franchisees* and the address and telephone number of each of their outlets," 16 C.F.R. § 436.5(t)(4) (emphasis added). Item 20 also requires franchisors to "[d]isclose the name, city and state, and current business telephone number, or if unknown, the last known home telephone number of every [former] *franchisee*." 16 C.F.R. § 436.5(t)(5).

Section 436.1(i) of the amended Rule defines "franchisee" as "any person who is granted a franchise." 16 CFR 436.1(i). The breadth of this definition of "franchisee" unquestionably includes current franchisees who have valid and enforceable franchise agreements, but have not yet opened an outlet, as well as former franchisees who never opened an outlet. Similarly, it includes non-traditional franchised businesses where there may be no physical outlet (e.g., an Internet business).

In making the required disclosure for current franchisees, franchisors may not be able to disclose "the address and telephone number" for an outlet that has not yet opened or where no physical outlet is required to operate the business. Where no outlet has opened, the required disclosure can be made by listing the name of the franchisee, the city and state where the franchise will be located (if a location has not yet been determined), and noting that an outlet has "not yet opened." If the franchisee has a business telephone number or email address where he or she can be contacted, that information should be provided in place of the telephone number of the outlet, since the purpose of this disclosure is to enable prospective franchisees to contact existing franchisees.

In making this disclosure for a current franchise that does not need a physical outlet to operate the franchise, the franchisor can comply by listing the name of the franchisee and noting that "no physical outlet exists." In this case, however, the franchisor should also disclose a business address and business telephone number for the franchisee, if either exists. If not, the franchisor should disclose the city and state where the franchisee is located together with an internet website address or email address where the franchisee can be contacted.

Similar information about a former franchisee who never opened an outlet, or whose franchise did not require a physical outlet, must be included in the separate listing of former franchisees in Item 20. In making that disclosure, however, a franchisor is required to disclose the franchisee's last known home telephone number if a reasonable effort to obtain a current business telephone

number is unsuccessful. If a former franchisee requests that alternative contact information be disclosed – such as an email address, post office address, or personal home address – then it is not a violation of the Franchise Rule for a franchisor to honor the request and substitute the alternative contact information for the last known home telephone number.

20. When a franchise broker seeks to induce franchise purchases by independently offering a rebate or similar payment from its own funds, must a franchisor disclose that fact? May such a rebate offer be limited in its duration?

    Answer: As a general matter, a Franchise Disclosure Document ("FDD") must include information about a franchise broker only if the broker both "grants a franchise and participates in the franchise relationship." Thus, unless a broker is a party to a franchise agreement under which it has post sale obligations to the franchisee, it is not a "subfranchisor" subject to disclosure obligations under the Rule. 16 C.F.R. § 436.1(k).

    If, as is more typical, a franchise broker has no contractual post-sale obligations to the franchisee, it does not "participate in the franchise relationship" and disclosures about the broker are not required by the Rule. Consequently, if such a broker chooses to offer a rebate or similar payment from its own funds independently of the franchisor, and does not receive a sales commission from the franchisor that has been inflated to cover the cost of the offered payment, nothing in the Rule would require the franchisor to disclose the broker's offer of a rebate or similar payment in its disclosure document.

    Similarly, nothing in the Rule would ordinarily restrict a broker's freedom to limit the duration of a rebate or similar offer. It is important to note, however, that a franchise broker is a "franchise seller" under the Rule because it "offers for sale, sells, or arranges for the sale of a franchise." 16 C.F.R. § 436.1(j). As such, a broker is subject to three Rule prohibitions that could be implicated if the impending expiration of a short-term rebate offer were to deprive a prospective franchisee of the rights these prohibitions are designed to protect: (1) The right to obtain a copy of the franchisor's most recent disclosure document and quarterly updates upon reasonable request before signing a franchise agreement (16 C.F.R. § 436.9(f)); (2) The right to review a franchise agreement that differs materially from the agreement attached to the FDD for at least seven days before signing it (16 C.F.R. § 436.9(d)); and (3) The right not to have to disclaim or waive reliance on the representations made by the franchisor in the FDD.

21. May a franchisor require a prospective franchisee to list the statements in the franchisor's disclosure document that he or she regards as material to his or her decision to sign the franchise agreement?

    Answer: No. Under the Franchise Rule, a prospective franchisee is entitled to regard as material each and every statement in a franchise disclosure document. The text of the Rule as well as the Compliance Guide make it clear that section 436.9(h) reflects a Commission finding that each disclosure required by the Rule is material to a prospective franchisee's investment decision.

    Specifically, a "franchise seller" may not "require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments." 16 C.F.R. §

436.9(h). (The definition of "franchise seller" in section 436.1(j) specifies that this term "includes the franchisor and the franchisor's employees," among others.) Forcing a prospective franchisee to designate certain select statements as "material" would invite the conclusion that statements not selected are not material, and a court reasonably could construe a franchisee's failure to select one or more particular statements as the prospective franchisee's waiver of reliance on those particular statements.

Therefore, any requirement that a prospective franchisee provide a list of the statements from the franchisor's disclosure document that the prospective franchisee regards as material would be contrary to the express terms of the prohibition in section 436.9(h), and would seek to accomplish indirectly what that provision directly prohibits.

22. If a prospective franchisee has received a UFOC disclosure document prior to July 1, 2008, but has not purchased a franchise by that date, must the franchisor provide the prospective franchisee with its Franchise Disclosure Document ("FDD") 14 calendar days before he or she pays any money or signs a binding agreement in connection with the proposed franchise sale?

    Answer: The Rule does not require a franchisor to give its FDD to a prospective franchisee who has already received a UFOC disclosure document prior to July 1, 2008, unless he or she makes a reasonable request for the most recent disclosure document and quarterly updates pursuant to Section 436.9(f) of the Rule.

23. Must a franchisor identify more than a single individual as a "franchise seller" on its Item 23 receipt, or must a franchisor supplement the receipt page if that is necessary to list every individual with whom a prospective franchisee has significant contacts before the sale is concluded? If any supplementation is required, would it trigger a new 14 calendar day waiting period before a sale may be completed, or may the supplementation be accomplished at the closing of a sale by requiring a purchaser to list all the individual franchise sellers with whom she has had significant contacts?

    Answer: As FAQ 12 indicates, franchisors must identify and include contact information in the Item 23 receipt for "each franchise seller offering the franchise." Unless a potential purchaser deals with only one individual before buying the franchise, identifying a single individual as the "franchise seller" may not comply with the requirement, and supplementation of the list of franchise sellers may be necessary to include any individual with whom the purchaser has had significant contacts – that is, contacts in which material representations are made about the franchise.

    FAQ 12 emphasizes that in preparing their disclosures, franchisors must limit the Item 23 receipt's identification of franchise sellers to the individuals with whom a particular potential purchaser actually has had or is reasonably likely to have significant contacts, rather than including every single franchise seller with whom any prospective franchisee in the U.S. might have some contact. Since not all of the individual franchise sellers with whom a particular potential purchaser may have significant contacts may be known at the time a franchisor furnishes the disclosure, FAQ 12 suggests several ways in which the receipt page may be supplemented to add or update the required disclosure before a sale is concluded. Any such supplementation will not trigger a new 14 calendar day waiting period because it does not alter the substantive disclosures

required by the Rule.

Item 23 places the burden on the franchisor, not on a prospective franchisee, to identify franchise sellers on the receipt page. As FAQ 12 suggests, it may be reasonable in some circumstances for franchisors to request a prospective franchisee's assistance in identifying which individual franchise sellers in their local area they have dealt with, but that is not to say that franchisors may

shift the disclosure burden of identifying franchise sellers to prospective franchisees. If, for example, a franchisor invites prospective franchisees to its headquarters for one or more days of discussions concluding with a franchise sale, as is not uncommon, the franchisor should know which of its officers and employees will have significant contacts with the prospect during those discussions.

24. Does a franchisor risk violating section 436.9(e) of the Rule if a prospective franchisee makes a reasonable request for the franchisor's Franchise Disclosure Document ("FDD") earlier in the sales process than required by section 436.2, but at a time when an applicable state franchise investment law prohibits the franchisor from providing its FDD to that prospect until an amendment reflecting a material change has been filed with or made effective by the state?

    Answer: As a matter of enforcement policy, Commission staff would not recommend initiation of an action to enforce section 436.9(e) in such a circumstance if the franchisor can demonstrate that it: (1) advised the prospective franchisee that it was revising its FDD to reflect a material change; and (2) delivered the revised FDD as soon as permitted by the applicable state law, but in any event at least 14 calendar days before the prospective franchisee signed a binding agreement with, or made a payment to the franchisor or an affiliate in connection with the proposed franchise sale.

    FAQ 14 generally deals with this situation, and provides advice applicable in most states. However, FAQ 14 does not address the existence of some state franchise investment laws that do not permit the delivery of disclosures after a material change has occurred until revised disclosures reflecting the change have been filed with the state or reviewed and made effective by state regulators.

    As FAQ 14 notes, nothing in the Rule requires a franchisor to stop offering and selling franchises while it is in the process of updating its disclosures to reflect a material change. However, the same cannot be said for state franchise investment laws. Consequently, Commission staff will not recommend initiation of enforcement actions in the circumstances discussed above.

25. Item 12 requires that a franchisor that does not provide an exclusive territory include a disclaimer underscoring that fact. What constitutes an "exclusive territory" that would permit a franchisor to omit this disclaimer?

    Answer: In accordance with its well-established usage in franchising, Commission staff construe the term "exclusive territory" to mean a geographic area granted to a franchisee within which the franchisor promises not to establish either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks or service marks.

    If a franchise agreement omits either aspect of this two-fold commitment (neither company-

If a franchise agreement omits either aspect of this two-fold commitment (neither company-owned nor franchised outlets within the territory), section 436.5(l)(5)(i) of the Rule requires the franchisor to insert the following disclaimer in Item 12:[1]

> You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.

Requiring the disclaimer quoted above when the franchisor does not establish company-owned or franchised outlets within the territory – but does reserve the right to make sales in that territory through alternative channels of distribution or competitive brands – would be inconsistent with the disclosure scheme in Item 12. In the case of both exclusive and non-exclusive territories, sections 436.5(l)(6)(i) and (iii) of the Rule separately require detailed disclosures about whether a franchisor reserves the right to sell through alternative channels or competitive brands. Consequently, the disclaimer is not necessary to prevent prospective franchisees from mistakenly believing that an exclusive territory includes protection against competition by the franchisor by either of those means.

With exclusive territory so construed, Commission staff believe that any explanatory footnotes to the disclaimer will be unnecessary given the requirements of sections 436.5(l)(6)(i) and (iii), and more likely to be redundant and confusing than to clarify. Thus, pursuant to § 436.6(d) of the Rule, which prohibits inclusion in the Franchise Disclosure Document of "any materials or information other than those required or permitted by part 436 or by state law not preempted by part 436," no explanatory footnotes should be included.

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[1] Under Item 12, therefore, non-traditional franchises that cannot make any such commitment because they do not grant a geographic territory (*e.g.*, internet-based franchises) are required to include the disclaimer.

26. Does the "insiders" exemption in Section 436.8(a)(6) allow a company that has not yet publicly offered or sold franchises to sell a franchise to a manager with two years of experience with the company without providing that manager with a Franchise Disclosure Document ("FDD")?

    Answer: No. The exemption from disclosure set out in Section 436.8(a)(6) is available only to an "individual with management responsibility for the offer and sale of the franchisor's franchises or the administrator of the franchised network." Until actual sales and operation of the franchise system has begun, a manager cannot acquire "responsibility for the offer and sale of the franchisor's franchises" and there can be no "administrator of the franchised network." Thus, sales to managers cannot be exempt until two years after the franchisor has begun public sales of

to managers cannot be exempt until two years after the franchisor has begun public sales of franchises. Nevertheless, the exemption is available to an "owner," "officer," "director" or "general partner," of a company both before and after it has begun public sales of franchises, who also meets the two-year requirement.

While the Statement of Basis and Purpose for the Rule ("SBP") indicates that the "insiders" exemption is intended not only for companies that have begun franchise operations, but also for start-ups that have not, the plain language of the Rule provision requires that managers have experience with the company *after* it has begun franchise operations. This restriction makes sense because an owner, officer, director or general partner of a start-up may be knowledgeable about franchising and have control over the terms of the contemplated franchise relationship, but a manager without actual experience with the company after it has begun franchising likely would not, and, therefore, would benefit from the disclosures in the FDD.

27. May a franchisor that makes a financial performance representation in Item 19 include a statement that the franchisor does not make any other financial performance representation and has not authorized its employees or representatives to do so?

Answer: Yes, a franchisor that makes a financial performance representation in Item 19 may include a statement that the franchisor does not make any other financial performance representation and has not authorized its employees or representatives to do so, provided the franchisor uses the statement set out below, with no modification, at the very end of its Item 19 financial performance representation:

> Other than the preceding financial performance representation, [name of franchisor] does not make any financial performance representations. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

(This statement closely tracks the disclosure prescribed in Section 436.5(s)(2) for franchisors that make no financial performance representations. However, the first sentence of the Section 436.5(s)(2) disclosure here is tailored to fit the situation where the franchisor does make a financial performance representation.)

FTC Staff are persuaded that the foregoing statement should be permitted notwithstanding the fact that Section 436.6(d) of the Rule prohibits franchisors from including any information in a Franchise Disclosure Document other than that "required or permitted by [the Rule] or by state law not preempted by [the Rule]." The Statement of Basis and Purpose for the Rule states:

> The Commission also recognizes that over the course of the years, franchisors have developed specific language approved by the states for compliance with the UFOC Guidelines. The Commission anticipates that . . . the Rule will be interpreted, *where consistent with the public interest*, in a manner that conforms with historic industry practices."[1]

FTC staff believe this to be an instance where the Commission's enforcement approach should be informed by a longstanding practice in the industry. Many franchisors routinely included a similar caveat in their Item 19 disclosures under the Uniform Franchise Offering Circular ("UFOC") Guidelines before the amended Rule took effect. The language prescribed above serves to alert prospective franchisees that no representative or employee of the franchisor is authorized to embellish the disclosure document by making a financial performance representation. It also tells prospective franchisees what to do if they receive such unauthorized financial performance representations.

Therefore, FTC Staff are persuaded that it would be consistent with the public interest to allow franchisors that make a financial performance representation in Item 19 to continue to inform prospective franchisees that they do not make, and do not authorize their employees and representatives to make, any other financial performance representation, provided the statement is made in exactly the wording set out above, with no additions, deletions, or modifications.

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[1] 72 Fed. Reg. , 15444, 15449 n.54 (Mar. 30, 2007) (emphasis added), available at http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf .

28. Section 436.5(t)(5) of the Rule requires disclosure in Item 20 of contact information for former franchisees. It also requires, "in immediate conjunction" with that information, a cautionary notice advising potential purchasers that their contact information may be

cautionary notice advising potential purchasers that their contact information may be disclosed if they buy a franchise and later leave the franchise system. May a franchisor disclose this information, including the required notice, in an exhibit or an attachment to its Franchise Disclosure Document ("FDD")?

Answer: Yes. A franchisor may disclose contact information for former franchisees in an exhibit or an attachment to its FDD, *provided*:

Many franchisors include the contact information for *current* franchisees required by Section 436.5(t)(4) by referring in Item 20 to an exhibit or attachment to the FDD that contains what is often a lengthy, multi-page listing of this information. Most franchisors want to be able to use the same approach in making the required disclosure of *former* franchisee contact information required by Section 436.5(t)(5).

Section 436.5(t)(5) requires disclosure only of contact information for franchisees who have left the system "during the most recently completed fiscal year or who have not communicated with the franchisor within 10 weeks of the disclosure document issuance date." As a result of the limited time frame, the number of former franchisees is likely to be reasonably small, and the disclosure of their contact information likely would take little space. This argues for a strict interpretation, requiring former franchisees' names and contact information to be included in the FDD itself at Item 20, as the Rule states, and not in an exhibit or attachment. This argument is strengthened by the additional requirement for the cautionary notice "in immediate conjunction" with the former franchisee contact information. The Rule unequivocally and unambiguously requires that this notice *must* appear clearly and conspicuously in Item 20. Therefore FTC staff rejects the notion that this required notice could be relegated to an exhibit or attachment.

Nevertheless, staff recognizes that placing contact information for both current and former franchisees in an exhibit or attachment reflects a certain symmetry and consistency, and at any rate is a longstanding compliance practice permitted by state regulators under the Uniform Franchise Offering Circular disclosure format before the FTC's Amended Rule took effect. The Commission has stated that the Rule should be interpreted, where consistent with the public interest, in accordance with industry compliance practices under the UFOC Guidelines. It is staff's opinion that the use of an exhibit or attachment for former franchisee contact information would be consistent with the public interest if the number of former franchisees is disclosed in the body of Item 20 and the cautionary notification appears "in immediate conjunction" with this disclosure and is repeated with the contact information in the exhibit or attachment.

- the franchisor discloses in Item 20 the number of former franchisees listed in the exhibit or attachment; and

- the franchisor includes the required cautionary notice both in Item 20 and in the exhibit or attachment.

29. If a new FAQ is issued that would necessitate revision of a franchisor's Franchise Disclosure Document ("FDD"), when must the franchisor revise its FDD?

Answer: FAQs represent the views of FTC staff who are responsible for enforcement of the Franchise Rule, and have not been reviewed, approved or adopted by the Commission. Nevertheless, staff is aware that on occasion FAQs interpreting the Rule may require some franchisors to revise FDDs that they previously have placed in use in non-registration states, or

that they already have filed in registration states. Since FAQs are intended to provide bright-line guidance on issues not directly addressed by the Rule, the Statement of Basis and Purpose, or the Compliance Guide, they may clarify the existence of obligations not previously understood as requirements of the Rule. Accordingly, in recognition of the costs of revising FDDs, FTC staff will not recommend enforcement action based on a new FAQ, as a matter of policy, until such time

after the new FAQ is issued as a franchisor is otherwise required to revise its FDD by the Rule or state law.

Thus, after the date a FAQ is issued, an FDD should be revised before any new filing required by a registration state of an FDD used in that state, and before any quarterly revision required by Section 436.7(b) of the Rule. In any event, a franchisor should revise its FDD to comply with all FAQs issued prior to the end of its fiscal year no later than the annual update required by Section 436.7(a) of the Rule. To assist franchisors in this effort, all future FAQs will state the date on which they are issued.

Issued: May 18, 2009.

30. Notwithstanding FAQ 4, if a franchisor's parent is the sole supplier of a good or service without which a franchise cannot be operated, must the financials of the parent be disclosed in Item 21?

Answer: Yes. FAQ 4 addresses only those circumstances in which "a franchisor's "parent happens to supply goods or services to franchisees," and "is no different from any other third-party supplier." It does not consider the case where the franchisor's parent is the only supplier of a good or service that is so essential to the franchise that the franchised business cannot be conducted without it.

As stated in the Statement of Basis and Purpose, "[t]o the extent that a prospective franchisee is asked to rely on a parent to perform post-sale contractual obligations or relies on a parent's guarantee, the financial stability of the parent becomes a material fact that should be disclosed." [1]

It is staff's view that, even in the absence of an express commitment in the franchise agreement for the franchisor's parent to provide a good or service that is so essential to the franchise that the franchised business cannot be conducted without it, this obligation is implicit in the contractual obligations of the parties. Accordingly, disclosure of the parent's financial statements in Item 21 is required in these circumstances.

Issued: May 18, 2009

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[1] 72 Fed. Reg. 15444, 15511 (Mar. 30, 2007).

31. Section 436.7(a) of the Franchise Rule requires a franchisor to revise its Franchise Disclosure Document ("FDD") within 120 days of the close of its fiscal year, "after which [it] may distribute only the revised document and no other disclosure document." If a franchisor's registration does not expire until after this annual update deadline, may the franchisor

continue to use a validly registered FDD in that state after the update deadline, until either: (a) the state completes registration of its updated FDD; or (b) the franchisor's prior registration expires? If so, and if the franchisor uses the same FDD in non-registration states, may it continue to use the FDD in those states as well?

Answer: As a matter of enforcement policy, FTC staff would not recommend initiation of an enforcement action against a franchisor that continues – after the 120-day annual update deadline, pending either completion of the state registration of the franchisor's updated FDD or expiration of the franchisor's prior registration (whichever comes first) – to make sales in a registration state using an FDD registered in that state. Nevertheless, after the annual update deadline, a franchisor may not use an FDD without updating it to make sales in any state other than a state with a franchise investment law in which the franchisor's registration remains in effect.

Section 436.7(a) of the Amended Rule establishes a firm deadline for the required annual update and gives a franchisor 120 after the close of its fiscal year to complete the update. (This is 30 days longer than the original Franchise Rule allowed.) The deadline ensures that prospective franchisees receive a disclosure document that is not stale, since many of the required disclosures provide information only for the prior fiscal year. Consequently, it important that the annual update deadline be firm.

FTC staff recognize, however, that although several state registration laws also require annual updates within 120 days after the close of a franchisor's fiscal year, the time required for completion of the registration process means that registration of an updated FDD may not occur until weeks or months after the deadline. If the Rule's annual update deadline were inflexibly enforced in those states, it would require a franchisor with a valid registration under state law to stop selling franchises until completion of the registration of its updated FDD. To resolve this tension between the amended Rule and state requirements, FTC staff do not interpret the amended Rule as requiring a franchisor with an FDD validly registered in a state to suspend sales in that state after the update deadline pending either completion of the registration of its updated FDD in that state, or expiration of the existing registration. Nevertheless, to ensure that prospective franchisees receive the most up-to-date information possible in non-registration states, a franchisor must use only an updated FDD after the annual update deadline.

Issued: May 18, 2009.

32. Section 436.5(u) of the Rule mandates that the financial statements required in Item 21 "be prepared according to United States generally accepted accounting principles ("GAAP"). May franchisors use financial statements to comply with Item 21 if an auditor issues a qualified opinion because the statements do not comply with FIN 46R issued by the Financial Accounting Standards Board ("FASB")?

Answer: No. The FASB is the ultimate authority on U.S. GAAP, and its issuance of FIN 46R has modified U.S. GAAP to require that an entity provide consolidated financial statements that include any other entity in which it has an interest, as the primary beneficiary, that may increase or decrease in value (a "variable interest entity").

Issued: May 18, 2009.

33. May a franchisor comply with Section 436.5(s) of the Rule by placing a financial performance representation ("FPR") in an attachment to its Franchise Disclosure Document ("FDD"), rather than in Item 19?

    Answer: No, because Section 436.5(s)(3) specifies that a franchisor "must state the representation in the Item 19 disclosure," 1and placing the FPR anywhere else would not be in the public interest because it could confuse and potentially mislead potential purchasers.

    Section 436.6(s)(1) requires a franchisor to begin any FPR with a prescribed prefatory statement that informs potential purchasers about the circumstances in which the Rule permits FPRs. The second sentence of the required statement contains the following language: "Financial performance information that differs from that included in Item 19 [is permitted in only two circumstances]." 2

    While a prior FAQ has allowed franchisors to relegate an Item 20 disclosure to an FDD attachment where it was consistent with the public interest because any risk of consumer confusion could be avoided,3such a risk would be created here by the required prefatory language if the FPR did not appear "in" Item 19, as required by § 436.5(s)(3). Because we think it important that potential purchasers clearly understand the Rule's requirements for FPRs, as the amended Rule is designed to ensure, it is staff's opinion that franchisors making an FPR must include each of the disclosures required by §§ 436.5(s)(3)(i) - (v) in Item 19 of the FDD, rather than in an exhibit or attachment.

    Issued: May 18, 2009.

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[1] 16 C.F.R. § 436.3(s)(3) (emphasis added).

[2] 16 C.F.R. § 436.3(s)(1) (emphasis added).

[3] FAQ 28.

34. Does a general release in a franchise agreement violate the prohibition in Section 436.9(h) of the Franchise Rule against requiring a prospective franchisee to disclaim or waive reliance on representations made in the Franchise Disclosure Document ("FDD")?

    Answer: Yes. Unless a general release in a franchise agreement expressly excludes claims arising from representations in the FDD, or its exhibits or amendments, it is staff's view that the release would violate this prohibition. This applies to any general release of claims that a prospective franchisee is required to sign as a condition of obtaining a franchise, whether in the franchise agreement or some other document.

    Issued: October 13, 2009.

35. Is a franchisor required to include in its Franchise Disclosure Document ("FDD") a statement that the financing it offers includes a waiver of a jury trial that will also constitute a waiver of

that right in litigation concerning its franchise agreement or other related agreements, if that is the case?

Answer: Yes. Section 436.5(j)(2) of the Franchise Rule requires a disclosure in Item 10 of the FDD of "whether the loan agreement requires franchisees to waive defenses or other legal rights," and if so, the franchisor must "describe the relevant provisions." Thus, a failure to disclose in Item 10

that the jury trial waiver in a financing agreement offered by the franchisor also waives that right in litigation involving the franchise or other related agreements would misrepresent the effect of the provision and violate the Franchise Rule where the other affected agreements lack an express jury trial waiver.

Issued: March 28, 2011.

36. Where Item 20 requires disclosures about "company-owned outlets," is that term intended to include not only outlets owned by the franchisor, but also affiliate-owned outlets that are "substantially similar" to the outlets offered by the Franchise Disclosure Document ("FDD")?

Answer: Yes. The references in section 436.5(t) of the amended Franchise Rule to "company-owned outlets" include outlets owned by affiliates of the franchisor that are "outlets of a type substantially similar to that offered to the prospective franchisee." [1] To be "substantially similar," an affiliate's outlets need not conduct business under the same trademark and system.[2] If the goods or services sold at the affiliate's outlets are "substantially similar" to the goods or services to be sold at the outlets offered by the FDD, those outlets must also be included with the franchisor's outlets in the Item 20 disclosures for "company-owned outlets."

Section 436.5(t) of the amended Rule removed the limitation in section 16 of the original Rule specifying that disclosures about franchised and "company-owned outlets" were required only "with respect to the franchisor and as to the particular named business being offered." [3] This was one of many changes made "to align the final amended Rule more closely to the UFOC [G]uidelines," [4] including the instruction added to the Guidelines in 1993 to include affiliate-owned units that were "substantially similar" to the franchisor's outlets in the "company-owned outlet" disclosures in Item 20.[5]

By requiring disclosures about "substantially similar" affiliate outlets in addition to outlets owned by the franchisor, the amended Rule prevents franchisors from hiding negative information. For example, franchisors cannot avoid disclosing a large number of repurchases of failed franchises by using an affiliate to repurchase them.[6]

Issued: March 28, 2011.

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[1] 16 CFR § 436.5(t)(1).

[2] Amended Rule Statement of Basis and Purpose, 72 Fed. Reg. 15444, 15502 n.603 (Mar. 30, 2007).

[3] Original Rule Statement of Basis and Purpose, 43 Fed Reg. 59674, 59616 (Dec. 21, 1978).

[4] 72 Fed. Reg. at 15501.

[5] Bus. Fran. Guide (CCH) [FTC and UFOC Disclosure Materials Transfer Binder] ¶ 5772, p. 8450 (Instruction v).

[6] See note 2, supra.

37. May a franchisor state in Item 12 that it grants an "exclusive territory" if it reserves the right to open franchised or company outlets in so-called "non-traditional venues" like airports, arenas, hospitals, hotels, malls, military installations, national parks, schools, stadiums and theme parks?

    Answer: No. Pursuant to FAQ 25, a franchisor may state in Item 12 that it grants an "exclusive territory" only if the franchisor contractually "promises not to establish either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks or service marks" within the geographic area or territory granted to a franchisee. A reservation of rights to open outlets selling the same goods or services under the same trademarks or service marks within a franchisee's territory negates any such commitment and triggers the Item 12 requirement to include a disclaimer stating that franchisees will not receive an exclusive territory.1

    FAQ 25 notes that it is consistent with the disclosure scheme in Item 12 for a franchisor to grant an exclusive territory yet reserve the right to make sales in the territory through other channels of distribution or competitive brands because Item 12 elsewhere specifically requires detailed disclosures about such potential competition.2 The required disclosures about "other channels of distribution such as Internet, catalog sales, telemarketing or other direct marketing" are limited by the examples provided, however, to sales not requiring a franchised or company outlet physically located in a franchisee's exclusive territory.

    Because "non-traditional venues" entail an outlet physically located in a franchisee's territory, we can find no principled basis for interpreting "other channels of distribution" to include them. Accordingly, it is staff's view that a franchisor that reserves the right to sell through such "non-traditional venues" must make the disclosure that it does not provide an exclusive territory.

    Staff recognizes that where a reservation of rights to make sales through "non-traditional venues" prevents a franchisor from offering an exclusive territory, Item 12 could be interpreted as prohibiting disclosure of the rights the franchisor is reserving. As a matter of enforcement policy, staff will not object to the inclusion of a disclosure in this instance of the specific rights the franchisor is reserving because it would not conflict with the mandatory disclosure that the franchisor does not grant an exclusive territory and the additional information would provide prospective franchisees with useful information about competition from "non-traditional venues."

    Issued: October 16, 2012.

[1] 16 C.F.R. 436.5(l)(5)(i) (requiring the statement: "You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.")

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.[1] 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.[2] 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.

Issued: July 2, 2014.

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[1] 16 C.F.R. § 436.1(d) (definitions of "[d]isclose, state, describe, and list each mean to present all material facts accurately, clearly, concisely, and legibly in plain English").
[2] FTC Franchise Rule Compliance Guide (May 2008), p. 135.

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