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Long-Delayed Revisions for Franchise Regs

Many inconsistencies between federal and states' disclosure requirements eliminated

For the first time in nearly 30 years, the Federal Trade Commission has announced substantial revisions to its franchise disclosure requirements. The FTC has been examining its franchise regulations for the past decade, conducting workshops and hearings, and soliciting feedback through public comment periods. The recently announced revisions are intended to reduce inconsistencies in federal and state disclosure requirements governing franchise sales, address changes in the marketing of franchises and new technologies (such as the sale of franchises through the Internet), and provide expanded disclosures concerning franchise relationships. The phase-in period for the new rule will be July 1, 2007, to June 30, 2008. Between those dates, either the current or the new rule format will be accepted by the FTC. After July 1, 2008, only the new disclosure format will be accepted.

Since 1978, the sale of franchises have been governed by the federal rules of disclosures promulgated by the FTC under its Trade Regulation Rule, titled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities" (the "Franchise Rule") 16 C.F.R. Part 436.

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The Franchise Rule, modeled after securities laws, is designed to provide prospective franchisees with sufficient information to weigh the risks of investing in a franchise.

In its current form, the Franchise Rule requires franchisors to provide prospective franchisees with various disclosures, such as the total cost of the franchise (the amount of royalty fees, initial franchise fee, initial investment, etc.), pertinent information concerning the franchisor (business experience, financial issues, litigation filed against the franchisor, the number of franchises, etc.) and the franchisor's and franchisee's obligations under the franchise agreement.

The FTC has determined that the revised Franchise Rule will no longer apply to business opportunities. The FTC's rationale is that business opportunities generally do not require the same level of investment as a franchise or require the same amount of dependency as a franchisee has on a franchisor. The revised Franchise Rule will also not apply to franchise locations outside the United States and its territories.

The FTC has expanded the exemptions to its disclosure requirements to include:

- Franchises requiring an investment of over one million dollars (not including unimproved land or amounts financed directly by the franchisor, its parent or affiliate).

- Franchises sold to "sophisticated individuals" with a net worth of over five million dollars and with over five years relevant experience.

- Franchises sold to selected company officers of the Franchisor.

One of the primary goals in amending the Franchise Rule was to harmonize the Franchise Rule with state franchise disclosure laws. Since the inception of the Franchise Rule, 15 states (including New York) have enacted their own disclosure laws. To comply with these states' disclosure laws, franchisors have been required to prepare offering circulars, which are commonly known as the Uniform Franchise Offering Circular (UFOC). In general, the revised Franchise Rule follows the UFOC disclosure requirements. In certain instances, the FTC has eliminated certain requirements in the UFOC format. Some examples include:

- The revised Franchise Rule does not require the Franchisor to disclose certain "risk factors." Under the UFOC format, some common risk factors include choice of law, forum selection, arbitration requirements, etc.

- The revised Franchise Rule does not require broker information to be disclosed.

- The revised Franchise Rule does not require the franchisor to provide detailed information concerning its computer system, software requirements or point-of-sale system. The fran-

chisor now only needs to provide a general description of these items.

- The format for disclosing transfers, cancellations, terminations and non-renewals has been modified. Under the prior disclosure requirements, certain franchise units may have been disclosed under multiple categories, resulting in an inflated effect of system turnover to a prospective franchisee. Under the revised Franchise Rule, this disclosure has been amended in a manner to eliminate the "double-counting" of the same unit.

In other instances, the FTC has required additional disclosure requirements than what is currently required under the UFOC format. Some examples include:

- The franchisor must disclose material lawsuits filed against the franchisee. Previously, the franchisor was only required to disclose lawsuits initiated by the franchisee. In addition, franchisors use of confidentiality clauses in settlement agreements have been limited to the extent they restrict a former franchisee's ability to speak about his prior experiences with the franchisor.

- The revised Franchise Rule provides for broader disclosures concerning the franchisor's affiliate and parent companies (if the parent guarantees the obligations of franchisor).

- The franchisor's disclosure documents must contain certain language in the event that the franchisee will not receive an exclusive territory under the franchise agreement.

- The franchisor must provide the franchisee with explanatory language concerning its renewal requirements, including a disclosure that a condition of renewal may include an obligation to sign a new franchise agreement with materially different terms.

- The franchisor must disclose any approved suppliers that are owned, in whole, or in part, by any officer of the franchisor.

- The franchisor is subject to increased disclosures over units that it controls that were bought and sold during the past five years. In such instances,

the franchisor must now provide a prospective franchisee with each prior franchise owner's contact information and the reason for the prior changes in ownership with respect to the unit now for sale.

- Financial Performance Representations (formerly titled "Earnings Claims") are still optional. However, if a franchisor does elect to provide financial performance information, it can provide financial information with respect to subsets of franchisees that share similar characteristics. For example, franchisees that have been operating for a certain period of time, or located in a certain geographical area may be grouped together for purposes of disclosing financial information. This can provide a franchisor with greater flexibility in its decision whether to disclose its historical financial information.

Another primary goal of the FTC was to update the Franchise Rule to adapt to changes in marketing and new technologies. Prior to the announced revisions, the Franchise Rule disclosure requirements did not contemplate the use of the Internet, electronic mail or other recent technological advances. Under the revised Franchise Rule, the disclosures will now be subject to the following requirements:

- The required disclosures must be provided to the franchisee at least 14 calendar days prior to executing the franchise agreement. Under the prior disclosure requirements, the franchisor was required to provide the franchisee with a copy of the UFOC at the first face-to-face meeting, and at least 10 days before executing the franchise agreement. The FTC's elimination of the first face-to-face meeting recognized that the advent of the Internet made this requirement obsolete and impractical.

- The 14-calendar-day period set forth above is not affected by any mutually agreed upon changes to the franchise agreement by the franchisor and franchisee. In the past, *any changes* to the franchise agreement, including changes negotiated by the franchisee, required the franchisor to provide the

franchisee with an updated version of the franchise agreement, which could then not be executed for an additional five-day period. Under the revised Franchise Rule, the completed franchise agreement must be delivered to the franchisee at least seven days prior to its execution. However, only changes unilaterally added by the franchisor would trigger a restarting of the seven-day period. Any changes negotiated and agreed upon by the parties would not toll or otherwise impact the seven-day period.

- Under the revised Franchise Rule, electronic disclosures are now permitted. This can be done via electronic mail or through the Internet. The FTC only requires that the franchisee must be able to store, download, print or otherwise maintain a copy of the disclosures for future reference.

In 1993, the UFOC guidelines were announced and, for most intents and purposes, soon became the unofficial national standard for franchise disclosures. The FTC substantially revised its Franchise Rule to reduce inconsistencies in federal and state disclosure requirements governing franchise sales, address changes in the marketing of franchises and new technologies, and provide expanded disclosures concerning franchise relationships.

In general, the revised Franchise Rule is more evolutionary than revolutionary. Many of the revisions in the Franchise Rule are logical updates, oftentimes already implemented by various states and required under the UFOC format.

The success of the FTC's efforts will be determined in the years to come. The revised Franchise Rule closely tracks the UFOC disclosure requirements, eliminating many inconsistencies between the federal and states' disclosure requirements. However, if the states review the revised Franchise Rule and require additional disclosures, then the FTC's efforts to minimize the inconsistencies between federal and state laws may be short-lived. ■