ROBERT G. HUTCHINS - LEGAL ESSAYS

Franchise Disclosure Documents

Preliminary Note

Franchising can be an effective means of financing a business expansion assuming the business lends itself to franchising and the franchise program is well designed. To sell franchises lawfully, though, franchisors must furnish line-item disclosure to purchasers in accordance with the Federal Trade Commission Franchise Rule. In a number of states they must also comply with statutes that require pre-sale registration and constrain post-sale franchise relationships. This Essay provides an overview of the resulting compliance burden.

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Introduction

On January 23, 2007, after a prolonged review period that began in the early 1990s, the Federal Trade Commission announced it had finally amended its long-standing Franchise Rule. Compliance with the amendments is voluntary during a 12 month phase-in period beginning July 1, 2007, but mandatory after July 1, 2008. The amended Rule builds on its predecessor by requiring that franchisors provide detailed pre-sale disclosure to franchisees. The Rule applies in all states, all US territories and the District of Columbia. It preempts state laws "to the extent of any inconsistency," but does not prevent a state from providing "equal or greater protection (for franchisees) such as (mandatory) registration of disclosure documents or more extensive disclosure." Accordingly, 15 states currently have franchise laws of their own and 14 of the 15 prohibit offers or sales without some form of registration unless an exemption is available. These states also provide franchisees with basic rights that supercede conflicting provisions in the franchise agreement and limit the circumstances under which franchisors can terminate or refuse to renew a franchise. The overall compliance burden is formidable for franchisors with multi-state programs.[1]

The Federal Pre-Sale Disclosure Requirement

The FTC Rule requires that fourteen days before paying any fee or signing a binding agreement, a prospective franchisee must be furnished with comprehensive written disclosure about the franchisor's legal and operating history, its financial condition, the franchised business and all relevant contracts. The subject matter is identified in the Rule by line-item supplemented by detailed instructions. It is not sufficient to refer a prospect to the franchisor's website, or to other publicly available information, although delivery of the disclosure document and contracts by electronic mail is permitted if certain safeguards are observed.[2]

A properly completed disclosure document resembles a short-form prospectus. It must be updated annually within 120 days after the franchisor's fiscal year end, quarterly if there are material adverse changes in the operative facts and in "real time" if there are material adverse changes in previously furnished financial information.

Not surprisingly, the question whether a given change is both adverse and financially material can be open to dispute. For example, under generally accepted accounting principles pre-paid franchise fees are shown on the franchisor's balance sheet as an asset (restricted cash) subject to an offsetting liability (to either earn or refund the fees). A substantial increase in pre-paid fees that occurs between balance sheet dates may be positive evidence of growth or negative evidence that the franchisor's current liabilities will soon exceed its available funds. The first interpretation would not require amended disclosure. The second may require "real time" disclosure of the franchisor's deteriorating financial position.[3]

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[1] The FTC Rule is found at 16 CFR 436. The 15 states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. All of them require pre-sale registration except Oregon, which imposes conduct and disclosure rules patterned on the FTC Rule, but does not require a filing. Michigan requires a notice filing, but not a full registration statement.

[2]. Internet communications are treated legally as though they were paper communications transmitted by post. Accordingly, to avoid the appearance of an unregistered public solicitation, emailed franchise documents must be directed to a named recipient at a specific URL address and must permit the recipient to confirm receipt by return email to a URL address maintained by the franchisor. Internet franchise offers, which theoretically are distributed worldwide, are permitted if they contain a legend clearly indicating that (a) the offer is made only to residents of states in which either the franchisor is duly registered or no registration is required and (b) no offer will be made in any registration state until the franchise is duly registered in that state. A prudent franchisor will avoid a general disclaimer and identify the states in which its offer is effective, e.g. "all states except Washington."

[3] Mere disclosure may not be sufficient to placate state regulators. Washington and California, for example, will not hesitate to impound all pre-opening payments due a financially weak franchisor until the payments have been earned. To avoid the negative impression created by a state-monitored impound, undercapitalized franchisors should escrow such payments voluntarily with a recognized financial institution and tout the escrow as a selling point.

Of course, a franchisor is not liable for the consequences of adverse changes that are timely disclosed. While the outlet status and financial position of any franchisor will change constantly in the ordinary course of business, even if nothing else does, such changes will not require amendment of the disclosure document until their cumulative impact is material. The practical result is that quarterly amendments are the norm and interim updates are reserved for discrete events that are clearly adverse. Current information important to *existing* franchisees is provided through newsletters, emails, telephone "hotlines," annual reports and personal visits.

Federal Exemptions

The FTC Rule does not apply to a franchise relationship with *any* of the following characteristics:

(1) The total payments required of the franchisee for the first 6 months of operations do not exceed $500;

(2) The franchisee has more than 2 year's experience in the franchised business *and* its franchise is only "fractional" because its reasonably projected first-year franchise sales will not exceed 20% of its total sales;

(3) The relationship constitutes merely a "leased department" in which a retailer permits a seller to conduct business from the retailer's location free from any requirement to purchase goods or services from the retailer, its affiliates or its designated vendors;

(4) The relationship is governed by the federal Petroleum Marketing Practices Act;

(5) The franchisee's initial investment, exclusive of unimproved land, is at least $1 million or the franchisee is an entity with a 5+ year business history and a net worth of at least $5 million;

(6) A 50% or more owner of the *franchisee* was, for at least the preceding 2 years, associated with the *franchisor* as a director, officer, partner, employee with authority over franchise operations or 25% or more owner; or

(7) No material term of the relationship is documented in writing.

State Pre-Sale Registration Requirements

All of the "registration states" except Michigan condition the right to offer a franchise on their prior approval of a documentary package called an "Application" or "Registration Statement." (Michigan requires only a short-form "notice filing." See note 1.) The current state guidelines for preparing an Application were published in 1993 by the North American Securities Administrators Association, or "NASAA." The guidelines include instructions for completion of a "Uniform Franchise Offering Circular," or "UFOC," copies of which are to be filed with the Application and provided to purchasers. The UFOC instructions are similar to those in the amended FTC Rule and they cover the same subjects.[4]

NASAA has recommended that, during the phase-in period for the amended FTC Rule, the states permit disclosure by either a UFOC or an FTC disclosure document. Thereafter, only the FTC format should be used. The states have agreed, subject to their right to provide franchisees with additional protection as contemplated by the FTC. Accordingly, franchisors must keep abreast of the franchise laws of each state in which they propose to offer franchises.

A full documentary package contains a "Franchise Registration Application" with a verified "Signature Page," a "Supplemental Information Page", a "Sales Agent Disclosure Form," two counterparts of the UFOC or FTC disclosure document, a registration fee (generally $500 to

[4] The current state instructions are available on the NASAA website at **www.nasaa.org**.

$700), an auditor's written consent to the inclusion of its reports on the franchisor's financial statements and a "Cross Reference Sheet," which ties each subject covered by the disclosure narrative to its counterpart in the franchise agreement.

The Application Page provides identifying information about the franchisor and also about any subfranchisors that will be active in the state. Subfranchisors may sell franchises for their own account. They have all the obligations of a franchisor and accordingly must register separately. That distinguishes them from "area franchisees" who merely operate multiple outlets.

The Supplemental Information Page lists the states in which registration has been completed or is contemplated. It also sets forth the franchisor's projected budget for the cost of providing franchisees with *financial assistance*, such as loan or lease guarantees, *goods*, such as real estate improvements, equipment and inventory, or *services*, such as consultation or training. The sources of the funds that will defray those costs must also be shown, including proposed borrowings by the franchisor or contributions to its capital. This information is used by regulators to determine whether the franchisor can perform its obligations. If that is in doubt, the Application may be denied, subject to the right to renew it if additional funding is obtained.[5]

The Sales Agent Disclosure Form contains identifying and background information for each person who will sell the franchise, including officers or employees of the franchisor and independent brokers. The required background information includes a 5 year employment history, plus a 10 year criminal and civil litigation history. The litigation history must describe all pending actions or past criminal convictions, administrative sanctions or civil judgments if based on violations of franchise or securities laws, or laws respecting fraud, embezzlement, restraint of trade, unfair or deceptive practices or similar transgressions.

The heart of the Application is the UFOC or FTC disclosure document. The NASAA and FTC formats are substantially similar, but not identical. Because its use will be mandatory after July 1, 2008, the FTC format is set out below. It is generally self-explanatory, but key terms are ambiguous on their face and a full explanation of them is available only in the FTC's lengthy "Statement of Basis and Purpose." Those lacking the stamina to read the Statement can resort to an abridged question and answer release captioned "Amended Franchise Rule FAQS."[6]

State Exemptions from Registration

The registration states exempt some limited transactions, such as those involving offers or sales by franchisees for their own account, by franchisors having a minimum net worth, or by franchisors that sell only to "accredited investors." In California and Washington, for example, the net worth required for franchisors claiming an exemption by virtue of their financial strength is $5 million and the exemption is subject to the filing of audited financial statements, plus a "Uniform Consent to Service of Process" and a copy of the franchise agreement.

State Conduct Rules - The Franchisee "Bill of Rights"

While the FTC Rule is confined to pre-sale disclosure, the state franchise laws are not. State laws provide franchisees with basic rights that are enforceable notwithstanding any contrary provision in the franchise agreement. They thus limit the means franchisors can employ to deal with underperforming franchisees, ensure product quality or protect intellectual property. The Washington statute is illustrative. It prohibits a franchisor from:

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[5] See also Note 3 respecting a possible fee impound requirement.

[6] The Rule, the Statement and the release can be found on the FTC website at **www.ftc.gov** by typing "updated franchise rule" in the search box on the home page, then clicking on "FTC Issues Updated Franchise Rule."

(1) Restricting a franchisee's right to join an association of franchisees;

(2) Requiring a franchisee to purchase products or services from the franchisor, an affiliate or an approved vendor unless the requirement is "reasonably necessary" and pro-competitive;

(3) Discriminating among franchisees unless the discrimination is reasonable, e.g. because of changed circumstances;

(4) Selling or leasing products or services to a franchisee for more than a "fair and reasonable" price;

(5) Obtaining a financial benefit from a person doing business with a franchisee without disclosing that fact;

(6) "Competing" within an exclusive territory granted to a franchisee;

(7) Obtaining a release from liability from a franchisee except in a negotiated settlement in which the franchisee is represented by independent counsel;

(8) Imposing any "standard of conduct" on a franchisee unless the standard is "reasonable and necessary;"

(9) Refusing to renew a franchise without "fairly compensating" the franchisee for the "fair market value" of personal property (inventory, equipment, etc.) purchased from the franchisor plus "good will;" or

(10) Terminating a franchise for other than "good cause," which is limited to (i) a material breach of contract that the franchisee has neither cured nor reasonably started to cure following written notice (that need not exceed 30 days); (ii) three such breaches within a twelve-month period; or (iii) the franchisee's bankruptcy, insolvency, abandonment of the franchise or conviction of violating "any law relating to the franchise business." Even if "good cause" exists, the franchisor must purchase the franchisee's reasonably accumulated inventory and supplies though not "good will," excess inventory or purely personal items.[7]

The FTC instructs franchisors to consult judicial anti-trust opinions for guidance respecting the legality of their pricing and territorial allocation practices, but that exercise is helpful only in the most general sense. The states themselves do not provide much guidance. The words quoted above from the Washington statute are not defined at all, which leaves the statute riddled with ambiguities and complicates the effort to devise and enforce an effective franchise agreement. For example, the statute purports to allow a franchisor to terminate a franchise for violation of "any law relating to the franchise business," apparently without regard to the impact of the violation. It may seem reasonable, therefore, to assume that the sale of adulterated food in violation of health regulations would always justify the termination of a hamburger franchise, but never an auto-repair franchise that merely had snack vending machines on premises. However, the violation by the hamburger franchisee may be an inadvertent, isolated occurrence that does no serious harm and is immediately remedied, while the violation by the auto-repair franchisee may reflect systematic cost-cutting, contempt for legal obligations and a pervasive disregard for the health of employees and customers.

Moreover, the relationship of a given law, as such, to a given franchise is often tenuous, unless we accept the shaky proposition that any law will relate to any franchise at some level. There are circumstances, in short, in which an aggressive franchisor cannot safely assume that its agreements, or its enforcement methods, comply with the applicable statute.

[7] See, RCW 19.100.180.

Nevertheless, a franchisor whose rights are challenged must bear the burden of proving that its program does comply. Under state law, a franchisor that fails to do so can be liable to the franchisee for treble damages, attorney's fees and costs. Its willful breach of the registration, disclosure or conduct requirements will subject it to both civil and criminal sanctions.[8]

The Disclosure Document

An FTC "disclosure document" begins with a cover page that identifies the franchisor, describes the franchised business briefly, sets out the total required investment or investment range and contains warnings about the perils of out-of-state dispute resolution and other key risks. It must also contain, verbatim, an annoyingly patronizing legend devised by the FTC staff that admonishes purchasers to read all documents carefully and contact the FTC with questions. There follows a series of 22 disclosure "Items" plus a form of receipt arranged as follows:

Item 1 The Franchisor, and any Parents, Predecessors and Affiliates

This Item requires disclosure of the principle characteristics of the franchised business (products, markets, distribution channels, competition, etc.), plus the identity, form of organization, business and franchising experience of the franchisor and its affiliates. "Franchisor" is defined as "any person who "grants a franchise and participates in the franchise relationship." The term includes subfranchisors, but not sales agents or brokers. (The FTC believes the phrase "grants a franchise" means to assume contractual responsibility for providing one and the phrase "participating in the franchise relationship" means to assume contractual responsibility for providing post-sale financial accommodations, goods or services. Neither meaning follows from the text of the Rule although the result is sound.)

"Parents" and "affiliates" are defined, in language borrowed from the securities laws, as persons having a control relationship with the franchisor. Thus, a "parent" controls the franchisor directly or through one or more subsidiaries. An "affiliate" is controlled by or in common control with the franchisor, etc. There is an anomaly here because only parents that take an active role in providing or guaranteeing the franchisor's performance need be identified. That permits the ultimate owner of an organization to avoid the disclosure obligation (and reduce the risk of personal liability) by delegating the franchise function to a specially formed subsidiary, a tempting proposition for an owner with an embarrassing business or legal history.

"Predecessor" means the person from whom the franchisor obtained the bulk of its initial assets, but the term refers to an organization; not a natural person. Thus, there is no "predecessor" of a corporate franchisor that purchased its initial assets with cash contributed by its founders.

Item 2 Business Experience

Every director, officer or other manager of the franchisor must be named in Item 2. A 5 year employment history must be furnished for each, replete with the names of the prior employers, the job locations and the starting and ending employment dates.

Item 3 Litigation

The franchisor must disclose any administrative, criminal or civil action involving an alleged violation of securities or franchise laws, or an allegation of other fraudulent misconduct, if the

[8] The FTC Rule provides for administrative sanctions, but not a private right of action. The states are not so limited. In Washington, for example, treble damages and attorney's fees can be awarded to franchisees under the Consumer Protection Act. Franchisors also face civil penalties imposed by the Department of Financial Institutions of up to $2,000 per violation. If the violation is willful, the criminal sanctions include a fine of up to $5,000 and imprisonment for up to 10 years. See, RCW 19.100.190 and 210.

action is pending against the franchisor, its parent or any of its other affiliates that incur obligations to franchisees, or against any manager named in Item 2. Any other action involving the "franchise relationship" to which any such person was party during the past year must also be disclosed regardless of the specific allegations or the outcome. Finally, for each such person, there must be disclosed a 10 year history respecting criminal convictions, criminal "nolo contendere" (no contest) pleas, administrative sanctions or any civil action in which the person was enjoined from further misconduct, held liable for the payment of money or paid money in settlement.

As is the case with sales agents, this disclosure must be furnished in detail including, for each lawsuit or other proceeding, the caption, forum, cause number, filing and termination dates, a summary of the allegations and a description of the relief granted or the terms of settlement.

Item 4 Bankruptcy

This Item requires disclosure of the jurisdiction, case number, filing date and discharge or plan confirmation date respecting any bankruptcy, reorganization or similar proceeding brought within the past 10 years, in the US or in any foreign nation, by or against the franchisor, its parent, any of its other affiliates or any of its key managers, together with the current name and address of the relevant debtor. The Item must also identify any such proceeding involving any unrelated entity if a current key manager of the franchisor was then a "principal officer" of the entity.

Item 5 Initial Fees

The franchisor must disclose its initial processing and franchise fees, plus all other fees or fee obligations to be paid or incurred by the franchisee prior to opening if the fee covers goods or services provided by the franchisor or an affiliate. The disclosure must indicate, for each fee, whether the amount is a fixed sum or range of sums and must describe any computation formula, the payment terms and any circumstances under which the fee is refundable.

Item 6 Other Fees

All fees payable by the franchisee after opening must be disclosed, in tabular form, in Item 6. These include as "fees" the price to be paid for initial inventory, plus all royalty, advertising, lease negotiation, construction, supplementary training, accounting or audit fees, etc. The table must identify the payee, any computation formula, the amount, the due date and any refund conditions for each fee and must add explanatory comments when necessary. If the fees are imposed by an advertising or purchasing cooperative, the disclosure must include the voting power held by members of the cooperative that are controlled by the franchisor.

Item 7 Estimated Initial Investment

This Item requires disclosure, again in tabular form with comments, of all estimated material expenses that the franchisee will incur to open. In addition to repeating the initial fees, the franchisor must describe the expenses or expense range for real property (purchased or leased), equipment, fixtures, construction, remodeling, decorating, initial inventory and the like, plus all security or utility deposits, business licenses and "other prepaid expenses." A category captioned "additional funds" sets forth the recommended working capital that the franchisee will need during the startup period, plus the factors used to determine the amount.

Item 8 Restrictions on Sources of Products and Services

Franchisors are acutely interested in ensuring the quality and consistency of their products or services and most impose restrictions on the sources from which franchisees can acquire them. The source will be the franchisor itself, an affiliate or an approved third party vendor. Such restrictions are generally permitted unless they are deemed anti-competitive or otherwise "unreasonable." Franchisors must turn to FTC staff opinions and judicial ant-trust decisions for guidance on the competitive impacts of their restrictive policies.

The franchisor must identify each restricted product or service then describe the specifications or performance standards for it, the reasons for restricting the source, the criteria for evaluating vendors, the circumstances under which the franchisee can purchase from alternative vendors, any commission or inducement paid by the vendor to the franchisor for being designated a source and any consideration above the market price paid by the franchisee.

The franchisor's principal drafting objective should be to turn this disclosure into a selling tool that emphasizes the high level of the franchisor's self-imposed performance standards and its diligence in qualifying and monitoring other vendors.

Item 9 Franchisee's Obligations

This Item, organized in tabular form, lists each material obligation imposed on the franchisee and identifies its source by agreement title and section or paragraph number. The table divides the obligations arbitrarily into 25 categories that cover the entire franchise relationship from site selection through termination, dispute resolution and "other" matters. The table also contains a cross reference, by Item number, to the relevant discussion in the disclosure document.

The obligations will usually be contained in more than one document (e.g. the initial franchise application, the franchise agreement, an escrow agreement if one is used, etc.) and there is no room in the table for extensive explanations. As a result, the response to Item 9 is necessarily cryptic and a legend must be inserted under the caption to the effect that the table is merely a guide to help franchisees locate the source and precise wording of their obligations.

Item 10 Financing

If the franchisor offers financing directly, through an affiliate, or by guaranteeing the franchisee's obligations, the material terms must be described in Item 10. The disclosure is similar to that required for consumer finance. The franchisor is given the option to provide this disclosure in tabular form and a sample Table is provided in an Appendix to the FTC Rule. However it is done, the disclosure must identify the debt being financed (e.g. the initial franchise fee, construction costs, etc.), the source of the financing (e.g. the franchisor, its affiliate or an approved lender or leasing company) and the interest rate, down and progress payments, required collateral, remedies for default and other material terms. The franchisor must also disclose whether it has the option of selling the franchisee's debt and, if so, the terms of the underlying assignment and the effect of the sale on the franchisee's rights and obligations.

Providing financing can be a lucrative component of a franchise program and an effective means of building a system, but the finance business requires special management skills. Credit markets carry complex risks that can escape the most sophisticated of professionals. That seemingly obvious fact is occasionally ignored by inexperienced franchisors, with disastrous results.

Item 11 Franchisor's Assistance, Advertising, Computer Systems and Training

Item 11 requires disclosure of the franchisor's obligations (and the franchisee's reciprocal responsibilities) as they apply (a) prior to the initial opening, (b) to pre-opening waiting periods, (c) to franchise operations, (d) to advertising and (e) to any required cash registers or computer systems. The discussion must cite the section or paragraph number of the franchise or other agreement that imposes the obligation.

Pre-opening training is to be described in narrative form and summarized in a table. The narrative must address the qualifications of the instructors, the frequency of the training classes, any training charges and the persons whose attendance is required. The table is organized by subject matter, hours of classroom or on-the-job training and location.

The advertising program must be disclosed comprehensively. In addition to any obligation it incurs to provide or pay for advertising, the franchisor must disclose the advertising source, the media used, whether the advertising is regional or national, whether there is an advertising council or cooperative for the franchise program and, if so, the degree to which the franchisor controls that organization. The franchisor must also describe the precise function of the organization and state whether franchisees may participate.

If franchisees pay an advertising fee, the franchisor must disclose the fee structure (e.g. voluntary, involuntary, payment dates, flat sum, fixed revenue percentage or formula), plus the content, format and frequency of the advertising to be provided in exchange and the manner in which the resulting advertising fund will be administered. The franchisor acts as fiduciary when receiving, holding and expending advertising fees and the disclosure reflects that legal reality.

The function, operational capacity, maintenance requirements and purchase or lease costs of required cash registers or computer systems must also be disclosed together with the degree of access the franchisee will have to information stored in the systems.

Finally, there is a curious requirement that the franchisor disclose the table of contents of its operating manual, plus the number of pages devoted to each subject and the total number of pages the manual contains, unless the franchisee has an opportunity to “view” the manual before “buying” the franchise. It is not clear how information about the number of pages will advance the franchisee’s decision-making. Nor is it clear how comprehensive a “view” is required before the disclosure may be omitted, or whether “buying” means committing to buy or paying. However, the manual is used as a reference tool in most pre-opening training and it can also be effective as a selling tool. The franchisor can protect itself against unauthorized use or disclosure of the manual in a preliminary document. A franchisor that does so can probably provide the requisite “view,” and shorten or omit its disclosure about the manual, without undue legal risk.

Item 12 Territory

When the franchise must be operated from a specific location, that fact must be disclosed together with the terms, if any, on which the franchisee may relocate or acquire additional outlets. The extent of any allocated territory must also be disclosed. Territories are typically described in terms of a radius measured in miles or population densities. In the latter case, if the radius will contract as the density increases, that fact must be stated.

If the territory is not exclusive, this Item must include a legend to the effect that the franchisee may face competition from the franchisor or other franchisees. If the territory is purportedly exclusive, the franchisor must disclose any exceptions, such as a retained right to sell franchised or similar products under its trademark using other distribution channels or the right to sell other franchises that operate or may operate in the territory. In the latter case, the franchisor must describe the method it will use to resolve disputes respecting customers and support services.

Item 13 Trademarks

Each “principal” commercial symbol used to promote the franchise is treated as a trademark. The franchisor must disclose whether the mark is registered with the US Patent and Trademark Office and, if not, whether an application for registration has been filed. Registration or application dates and identification numbers must be included. If a mark is registered, the franchisor must state whether the registration is on the “Principal” or “Supplementary” register. Any contractual limitation on the right to use the mark must be disclosed along with full details respecting any third party claims asserting a prior right to the mark, alleging infringement, or otherwise purporting to deny or limit the right of the franchisor to exploit the mark. Any obligation of the franchisor to defend the mark or compensate franchisees if their use of the mark is terminated or materially restricted must also be described or disclaimed.

Item 14 Patents, Copyrights, and Proprietary Information

The rights, limitations and any claims respecting any patent, copyright or other non-trademarked intellectual property owned, applied for or licensed to the franchisor must be disclosed in Item 14. The format for disclosing registration dates, names and numbers, relevant contractual provisions and adverse claims is equivalent to that used in Item 13 for trademarks, but some additional narrative is required. The franchisor must describe the "nature" and "duration" of each patent or copyright and its "relationship" to the franchise, since that information may not be self-evident.

The franchisor must state whether it intends to *renew* any copyright. Since intentions can change, a prudent franchisor should disclaim any *obligation* to renew here and in the franchise agreement.

Item 15 Obligation to Participate in the Actual Operation of the Franchise Business

The operation of the typical franchised outlet is a small business endeavor. Most outlets are owned by sole proprietorships or family entities. The franchisor can evaluate the owners, but has only an indirect relationship with their employees. As a result, while the franchise agreement can obligate franchisees to hire only employees who have attained a minimum educational level, acquired specific skills, completed initial training or agreed to protect proprietary information, most franchisors insist that the owners themselves supervise all operations.

Item 15 requires disclosure of any obligation of the franchisee to participate personally in the "direct operation" of the franchise whether the obligation arises "from any written agreement or from the franchisor's practice." It is difficult to see how the "practice" of the franchisor could create a legal obligation except through a course of dealing in which the obligation was tacitly accepted by the franchisee. I doubt any franchisor would rely on a reed that slender. If the franchisor's objective is to impose a personal management obligation it should do so in writing.

Franchisors must also disclose whether an owner's personal participation is recommended, even if it is not required. If "on-premises" supervision is not required, the franchisor must disclose all qualifications required of employees and managers (e.g. basic education, training etc.).

Item 16 Restrictions on What the Franchisee May Sell

The franchisor must disclose all restrictions or conditions that affect what the franchisee may sell or that limit access to customers. These include any obligation to sell *only* goods or services approved by the franchisor, or *all* such goods or services. If the franchisor has the right to change approved goods or services that right must be disclosed, together with any limitations.

Since the FTC Rule and applicable state laws require that such restrictions be pro-competitive, this Item should explain the criteria used by the franchisor to determine competitiveness (e.g., market-based pricing, quality standards, required specifications, on-time deliveries, etc.). The franchisee's temporary right to purchase goods or services on the open market during any period when approved vendors cannot deliver them on a competitive basis should be disclosed, together with the method for determining when such vendors can resume competitive deliveries.

Item 17 Renewal, Termination, Transfer and Dispute Resolution

This Item presents, in a three column table, an identification of each material contractual provision that effects the franchise term, its renewal or termination, the transfer of a franchise by the franchisee, the consequences of the death or disability of the franchisee, any restraints on the franchisee's right to compete during or after the franchise term and the manner in which disputes are to be resolved. The table contains a summary of each provision and a cross reference to the relevant franchise or other agreement. In a manner reminiscent of Item 9 (Franchisee's Obligations), the provisions are arbitrarily divided into categories, in this case 23 of them.

The table is captioned "The Franchise Relationship." Immediately beneath the caption there must be a legend to the effect that the table merely lists important provisions that the franchisee should review by reading the disclosure document and the relevant agreements.

The provisions disclosed in this Item are impacted by state laws creating the so-called "franchisee bill of rights." For example, states with such laws will not enforce limitations on the franchisee's right to compete after the franchise ends if they view the limitations as unreasonable, although the same states agree that restrictions prohibiting unauthorized use of the franchisor's intellectual property are fully binding. A requirement that the franchisee submit to arbitration or litigation of disputes in a foreign jurisdiction may be unenforceable in several states. Most state franchise laws require that legends be inserted in the disclosure document advising franchisees that state laws will prevail over contrary provisions in the franchise agreement.

Item 18 Public Figures

For the purposes of Item 18, a "public figure" is "a person whose name or physical appearance is generally known to the public in the geographic area where the franchise will be located." Ed McMahon would presumably be a "public figure" in any area of the country, while an NFL running back playing for a west coast team might not be "generally known" in Maine.

Problems of definition aside, a prudent franchisor will identify as a "public figure" anyone who has been the subject of more than a modicum of publicity and who endorses the franchise in the disclosure document or in broadcast or print media. Not surprisingly, Item 18 also requires disclosure of all forms of compensation paid or promised for an endorsement and of the extent, if at all, to which the public figure is involved in management or control of the franchisor. This last must include a description of the public figure's position, duties, underlying investment and form of investment (e.g. stock, debt instruments, etc.).

Item 19 Financial Performance Representations

The first questions most prospective franchisees want answered concern the financial rewards they can anticipate from operating their outlets. A franchisor may make financial performance representations, called "earnings claims" in the UFOC format, if based on reasonable, substantiated assumptions that are set forth in Item 19. A franchisor that disclaims such representations must substitute a legend that warns prospects to disregard any financial performance or earnings claims by the franchisor's representatives and report them to the FTC and state authorities.

When representations are made, Item 19 must disclose whether they reflect historical system-wide financial performance or only the performance of a "subset" of outlets that share common characteristics, such as size, geographic location, population demographics, competitive environment, etc. The characteristics, and any departures from them, must be described fully together with the number of franchisor owned outlets included in the database. The remaining disclosure must set forth the dates or time periods by or within which "the reported level of financial performance was achieved," plus the total number of outlets included in the database, the number that attained or surpassed the stated results and all other material assumptions.

A franchisor should consult with its accountants before making any financial performance representations. Ideally, the representations would be presented as pro forma financial statements, formatted in accordance with generally accepted accounting principles, that show the anticipated first year-end financial condition and first year results of operations for a typical outlet. The footnotes should set forth all material assumptions.

Item 20 Outlets and Franchisee Information

In Item 20, the franchisor must disclose several categories of information about its current, projected and former outlets and its current and former franchisees. First, five tables show historical and projected changes in the number and composition of the outlets. The instructions include samples of the format for each table. The historical changes cover each of the franchisor's last three fiscal years or each year or partial year of any operating history less than three years. The projected changes cover the succeeding 12 months.

Tables one through four disclose historical changes in the number of owned, franchised, transferred, terminated, non-renewed and reacquired outlets. These tables include both state-by-state and system-wide totals as of the beginning and end of each reported year plus a final column showing the net change for the year. Table five shows the projected state-by-state and system-wide openings of owned and franchised outlets. It must include the number of franchise agreements signed for outlets that are not yet opened.

Second, Item 20 must include the name of and the personal address, telephone number and outlet address (or addresses) for each *current* franchisee, up to a maximum of 100. The franchisor must begin the count with the franchised outlets in its home state then expand the count outward through contiguous and neighboring states to the extent necessary to reach the maximum. It must then add the name of and the last known personal contact information and former outlet address (or addresses) for each *former* franchisee whose franchise was terminated or not renewed or who ceased operations during the last fiscal year, with no numerical limit. If the franchisor is currently selling a reacquired outlet, Item 20 must include the name of and contact information for each former franchisee that operated the outlet during the last five fiscal years, plus the time period for each operation and the reasons for each termination. "In conjunction" with that information, the franchisor must include a legend warning prospects that "(if) you buy this franchise, your contact information may be disclosed to other buyers when you leave the franchise system." (Since contact information will be disclosed for up to 100 buyers while they are *in* the system, the legend is presumably directed at buyers of established franchises and is meant to remind them of the negative inferences associated with termination.)

Third, Item 20 must disclose the number and percentage of franchisees that signed confidentiality undertakings during the last three fiscal years. If any were signed, a legend must be added warning prospects that the undertakings may prevent existing franchisees from speaking "openly" about the franchise. The franchisor may defend the undertakings by explaining their purpose (e.g. to protect the franchisor's intellectual property).

Finally, the franchisor must disclose, to the extent known, the name of and contact information for each "trademark-specific" franchisee organization associated with the system if the franchisor endorses the organization or the organization is named in the disclosure document. Any formal relationship with the organization must be explained. If the organization is independent of the franchisor, a legend may be added to the effect that it asked to be named.

Item 21 Financial Statements

The franchisor must furnish audited balance sheets for a maximum of each of its last two fiscal year-ends, plus audited statements of operations, stockholders equity and cash flows for each of its last three fiscal years, prepared in accordance with generally accepted accounting principles.

Alternatively, a franchisor may furnish audited financial statements for an affiliate covering the same periods if the affiliate guarantees unconditionally the franchisor's obligations to franchisees. The guaranty need not extend to third parties. Separate financial statements must be furnished for any subfranchisor and for any parent that guarantees or agrees to perform the franchisor's post-sale obligations. The text of any guaranty or post-sale performance agreement must be included.

Startups that do not yet have audited financial statements must disclose that fact "conspicuously." They may phase-in the statements by providing, in sequence, an unaudited opening balance sheet, then audited balance sheets and statements of operations, etc. at and as of the end of its first fiscal year or partial year and each subsequent year until they can furnish audited financial information for the full required reporting periods.

Item 22 Contracts

Copies must be attached to the disclosure document of all proposed contracts relating to the franchise, including the franchise agreement and any purchase, marketing, confidentiality, option or escrow agreement. As noted, Items 9, "Franchisee's Obligations" and 17 "Renewal, Termination, Transfer and Dispute Resolution" are cross referenced to the relevant contractual provisions.

Item 23 Receipts

The FTC's form of receipt to be signed by the prospective franchisee is set out in Item 23. A detachable execution counterpart must be included with the disclosure document. The form identifies the parties, contains contact information for the franchisor and repeats the earlier admonition that the disclosure document and all agreements should be read carefully. The form also contains an acknowledgement by the prospect that the franchise documents, all of which are to be named, were received at least 14 days prior to the date the prospect made a payment or signed a binding agreement in connection with the franchise.

Some states, including California and Washington, have their own form of receipt to be signed by prospects residing within their borders. The state forms add legends to the effect that state franchise laws will prevail over the franchise agreement and that certain provisions of that agreement, such as those limiting post-term competition by the franchisee or requiring that disputes be arbitrated or litigated in a foreign state, may be unenforceable. These legends, when added to those appearing elsewhere, ensure that the prospect is thoroughly, indeed repeatedly, warned of the potential pitfalls of investing in the franchise.

Contact Information for State Franchise Administrators

Several legends in the disclosure document encourage franchisees to call the FTC and state administrators if they believe the franchisor has violated the FTC rule or applicable state laws. Relevant contact information must be provided. A list containing that information for all state administrators can be found on the NASAA website at **www.nasaa.org**.

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