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**THE APPLICABILITY OF U.S. FRANCHISE LAWS
TO FOREIGN FRANCHISORS
ENTERING THE U.S. MARKET**

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I. INTRODUCTION

In preparing this paper, it became clear that most of the information regarding international franchising in legal articles and other publications focuses on U.S. franchisors expanding outside of the United States into Europe, Asia, Latin America, and nearly every other country. There was very little information regarding the converse, that is, franchisors from other countries coming to the U.S. This may be expected due to factors such as the maturation of the domestic franchise industry and the saturation of certain industry segments, the overall “globalization” of the economy, etc. These same factors are beginning to exist in other countries together with the fact that the U.S. is one of the best markets in the world, with political stability, financial stability, open markets that welcome foreign investment, and high per capital income.

It has become increasingly clear that the business expansion model of franchising, as a viable method of distribution, cannot be questioned, given the proper circumstances. There comes a point in the evolution of a franchise system that international expansion is examined. The same factors that cause or enable a U.S. franchisor to engage in international franchising apply to a foreign franchisor deciding to go beyond its domestic market.

There are many foreign franchisors franchising in other countries. In many of these transactions there are no franchise regulations affecting the transaction, as both countries have no franchise laws. A foreign franchisor entering the U.S. market has a rude awakening in the myriad of federal (U.S.) and state laws and regulations confronting it. The United States was the first country to adopt franchise laws (California 1970) and has the most complex and extensive franchise laws in the world. It now appears that other countries are seeking to emulate the U.S. in franchise pre-sale disclosure and registration laws but with less extensive disclosure. Importantly, the U.S. does not restrict equity ownership by foreign investors in U.S. businesses except for certain business relating to national security. There are no legal restrictions of the repatriation of U.S. profits to a foreign investor except for U.S. tax laws and treaties.

The U.S. franchise laws will apply to a foreign franchisor seeking to sell franchise rights, area development (multi-outlet) rights, master franchise (subfranchise) rights and area representative (development agent) rights with the United States including its Territories. In the same manner that the U.S. counsel to a U.S. franchisor retains legal counsel in the foreign country for assistance, a foreign franchisor is well advised to also retain U.S. franchise counsel when entering the U.S. market. There has developed a number of international franchise expansion models that may apply to the transaction, although the most typical is international master franchising. These various international franchising expansion models will be discussed after an analysis of federal and state franchise laws. This paper discusses the franchise law issues in developing a franchising plan and the strategy for entering the U.S. market.

Of course, many other laws and regulations may affect the foreign franchisor and master franchisee that must be examined including trademark laws, antitrust laws, corporate laws, labor laws, etc. In addition the transaction may be subject to state business opportunity laws or be considered a true license agreement, distributorship, dealership, or independent sales representative arrangement. These laws are outside the scope of this paper.

II. U.S. FRANCHISE LAWS

HISTORICAL BACKGROUND.

While franchising is believed to have first begun in the 1850's by Singer Sewing Machine Company, it was not until the 1950's when it really started to boom, particularly in the fast food and hotels/motels industries. During this time there were no franchise laws to speak of. During the '50s and '60s people who sued the franchisor thinking they got a raw deal, in addition to claiming fraud and misrepresentation, argued that the franchise they bought was an unregistered "security" in violation of federal and state securities laws. Unfortunately, the courts did not agree concluding that a franchise was an active investment and not a passive investment and was not an "investment contract" type of security regulated by the securities laws.

As a result of these decisions, the securities regulators thought that, if a franchise was not a security, then "there ought to be a law" specifically addressing franchising. In 1970, California enacted its Franchise Investment Law requiring the prior registration and approval of the franchisor, including the creation of a disclosure statement containing information about the franchisor and the franchise offering to be given to prospective franchisees before they bought the franchise. The Midwest Securities Commissioners Association, in reaction to the inability to regulate franchising using their existing states' securities laws, developed in 1975 a franchise disclosure and registration law called the Uniform Franchise Offering Circular ("UFOC"). Eventually, from 1975 through 1980, 15 states adopted the same or similar versions of this law. Currently 10 states require complete registration. Nine other states require less extensive registration. If the franchisor does not a federal registered trademark there are 3 other states requiring registration as a business opportunity. If the franchisor does not have a state trademark registration, there are several other states where the franchisor must register as a business opportunity.

In 1978, the Federal Trade Commission ("FTC") decided that nationwide, federal regulation was necessary. It adopted the FTC Franchise Rule, similar to, but not identical to, the UFOC. Since the UFOC Guidelines provide for greater disclosure to prospective franchisees it was not preempted (overruled) by the FTC Franchise Rule, thereby creating dual (federal and state) regulation.

FEDERAL DISCLOSURE LAW - THE FTC FRANCHISE RULE

In 1978, effective October 23, 1979, the FTC adopted a rule formally titled "Federal Trade Commission Rule Regarding Franchising and Business Opportunity Ventures Disclosure Requirements and Prohibitions" (16 C.F.R. Part 436). It is generally referred to as the "FTC Franchise Rule." It governs the offering for sale of franchisees in all 50 states, Puerto Rico and the U.S. Virgin Islands. It is a disclosure law (that is, tell the people what the deal is) and does not regulate the relationship between the franchisor and the franchisee (that is, the terms of the franchise agreement). The franchisor does not register its franchise offering with the FTC or any other federal agency. The FTC does not approve or endorse the franchise offering.

The FTC Franchise Rule has been amended twice, most recently in 2007, requiring franchisors to comply with the new FTC Franchise Rule as of July 1, 2008. The FTC Franchise Rule now requires a franchisor to give to a prospective franchisee a Franchise Disclosure Document ("FDD") containing information about the franchise company, its principals and details about the franchise and the franchise agreement. The FDD must be given to a prospective franchisee: at least 14 days before the franchisee signs any franchise-related agreement or the franchisor receives any money from the franchisee. The franchisee must also receive a franchise agreement containing all material terms at

least 7 days before signing the franchise agreement. The 14-day and 7-day periods can run at the same time.

The information contained in the FDD must be current as of the close of the franchisor's most recent fiscal year (usually December 31). The franchisor has 120 days after the end of each fiscal year in which to prepare an updated FDD (usually April 30). Any "material" change in the information must be disclosed in a supplement to the FDD at least quarterly (for example, an increase in fees, quarterly financial statements showing material changes, or franchise sales and/or terminations showing material changes, etc.). The FDD must be updated annually and the information contained in the quarterly supplements must be included in the body of the FDD.

The FTC Franchise Rule preempts (supersedes) state law only if there is conflict between the two, and also if the FTC Franchise Rule affords greater protection to a prospective franchisee. Where state law affords greater protection, state law is not preempted and a franchisor must also comply with state law.

BUSINESSES COVERED BY THE FTC FRANCHISE RULE

There are 2 types of continuing commercial relationships are defined as a "franchise" and covered by the FTC Franchise Rule (1) business format franchise; and (2) product franchise. A "franchise" means that the franchisee: (a) sells goods or services that meet the franchisor's quality standards [(in cases where the franchisee operates under the franchisor's trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor ("mark"))] or which are identified by the franchisor's mark; (2) the franchisor exercises significant control over, or gives the franchisee significant assistance in, the franchisee's method of operation; and (3) the franchisee is required to make a payment of \$500 or more to the franchisor or a person affiliated with the franchisor at any time before to within 6 months after the business opens.

Relationships covered by the Rule include: (i) those that are within the definition of "franchise;" and (ii) those that are represented as being within the definition when the relationship is entered into, regardless of whether, in fact, they are within the definition.

EXEMPTIONS FROM THE FTC FRANCHISE RULE

The FTC Franchise Rule contains 8 exemptions

1. **Fractional Franchise** - The FTC Franchise Rule contains an exemption from disclosure for a "fractional franchise." A "fractional franchise" is any relationship represented as a franchise in which the franchisee, or any of the current directors or officers of the franchisee, has been in the type of business represented by the franchise relationship for more than 2 years, and under which the parties to the franchise anticipated, or should have anticipated, at the time the franchise relationship was established, that the sales arising from the relationship would represent no more than 20% of the gross sales in dollar volume of the franchisee.

2. **Lease Department Store Departments** - Where, under a lease, license, or similar agreement, a person goods or services at premises occupied by a retailer-grantor primarily for the retailer-grantor's own merchandising activities, which goods or services are not purchased from the retailer-grantor or persons whom the lessee is directly or indirectly (A) required to do business with by the retailer-grantor or (B) advised to do business with by the retailer-grantor where such person is affiliated with the retailer-grantor.

3. **Minimal Payments** - Where the total of payments made during a period from any time before to within 6 months after commencing operation of the franchisee's business, is less than \$500.
4. **Absence of Writing** - Where there is no writing which evidences any material term or aspect of the relationship or arrangement.
5. **PMPA** - Franchise relationships covered by the Petroleum Marketing Practice Act.
6. **Large Investment** - Where the franchisee's estimated investment exceeds \$1,000,000, excluding financing or monies received from the franchisor or an affiliate, and real estate costs.
7. **Sophisticated Franchise** - a business entity franchisee having been in business for at least 5 years and a net worth of at least \$5,000,000.
8. **Insider Exemption** - Where a person owning at least 50% of the equity interest of a business entity franchisee within 60 days of the sale has been an officer, director, general partner or individual with management responsibility of the franchisor's franchise sales program or the administration of its network, or has been an owner of at least 25% interest in the franchisor.

EXCLUSIONS FROM THE FTC FRANCHISE RULE

The Rule excludes (1) relationships between employer/employees, and among general business partners; (2) membership in retailer-owned cooperatives; (3) certification and testing services; and (4) single trademark licenses.

NO FEDERAL RELATIONSHIP LAW

Surprisingly, there has been no federal franchise relationship law enacted by the U.S. Congress. The most recent alliteration was in 1998, H. B. 4841, the Small Business Franchise Act of 1998. The closest to federal regulation is the voluntary Fair Franchising Standards of the American Association of Franchises and Dealers, which addresses abusive franchise agreement provisions and abusive franchise practices. The AAFD Fair Franchising Standards can be downloaded at www.AAFD.org. The International Franchise Association has a voluntary Code of Ethics but the Code is not strong and as long as the franchisor follows the letter of the franchise agreement, no matter how one-sided and abusive, the franchisor is not acting unethically..

III. STATE FRANCHISE LAWS

There are basically 2 types of state franchise laws: (1) laws requiring the registration and approval of a franchise offering before an offer or sale is made (registration and disclosure laws); and (2) laws regulating the franchise relationship in some manner (franchise relationship laws). If a U.S. subsidiary of a foreign franchisor is located in a state having a franchise law, it may apply to the U.S. subsidiary. In addition, the states where the prospective franchisee is a resident and the state where the franchised business is to be located may also apply. Theoretically, a transaction could be subject to the franchise laws of 3 states.

A Summary of Franchise Regulation by State appears on pages 8 and 9.

STATE DISCLOSURE AND REGISTRATION LAWS - 2008 GUIDELINES

In light of the new FTC Franchise Rule, the states have amended their registration and disclosure laws (the "Franchise Filing States") and the North American Securities Administrators Association, Inc. has amended and restated the Uniform Franchise Offering Circular Guidelines (UFOC Guidelines), now called the 2008 Franchise Registration and Disclosure Guidelines. The Franchise Filing States are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Other states having business opportunity laws will also have to be addressed. If the foreign franchisor's principal mark is not currently registered on the Principal Register of the U.S. Patent and Trademark Office, the U. S. subsidiary may have to also register as in business opportunity in a number of states beside the Franchise Filing States. A list of the 23 items of disclosure under the new FDD appears below.

FDD DISCLOSURE CATEGORIES

1. **The Franchisor and Any Parents, Predecessors and Affiliates** - Identity of the Franchisor and any Parents, Predecessors and Affiliates - description of the franchise business, and prior business experience of the franchisor regarding the business to be operated as a franchise.
2. **Business Experience** - Identity and business experience of the franchisor's directors and principal officers, and their occupations and employers, within the past 5 years.
3. **Litigation** - Litigation history of the franchisor and its directors, principal officers and franchise brokers during the previous 10 years both as plaintiff and as a defendant.
4. **Bankruptcy** - Bankruptcy history of the franchisor, its officers and directors during the previous 10 years.
5. **Initial Fees** - The franchisor's initial franchise fee or other initial payments such as an Initial Franchise Fee.
6. **Other Fees** - Recurring or isolated fees or payments required of the franchisee such as a Royalty Fee.
7. **Estimated Initial Investment** - Initial investment requirements of the franchisee to all parties and for the first 3-6 months.
8. **Restrictions on Sources of Products and Services** - Obligations of the franchisee to purchase or lease from designated sources and purchase or lease in accordance with specifications or from approved suppliers.
9. **Franchisee's Obligations** - A checklist of what the franchisee is obligated to do under the franchise agreement.
10. **Financing** - Financing arrangements offered directly or indirectly by the franchisor or an affiliate.
11. **Franchisor's Assistance, Advertising, Computer Systems and Training** - Obligations of the franchisor; other supervision, assistance or services.

12. **Territory** - A description of any exclusive area or territory granted to the franchisee.
13. **Trademarks** - Information about trademarks and other proprietary symbols.
14. **Patents, Copyrights and Proprietary Information** - Information about patents and copyrights and proprietary information.
15. **Obligation to Participate in the Actual Operation of the Franchise Business** - Requirements for the franchisee, or affiliated person, to participate personally in operating the franchise.
16. **Restrictions on What the Franchisee May Sell** - Restrictions on goods or services offered by the franchisee.
17. **Renewal, Termination, Transfer and Dispute Resolution** - Renewal, termination, repurchase, modification and assignment of the franchise agreement and related information.
18. **Public Figures** - Arrangements with public figure involvement.
19. **Financial Performance Representations** - Disclosures regarding earnings capability.
20. **Outlets and Franchisee Information** - Information regarding franchises of the franchisor.
21. **Financial Statements** - Last 3 years audited plus current balance sheet and a 3-years phase-in of audited financial statements for a start-up franchisor.
22. **Contracts** - Copies of franchise agreement and related contracts.
23. **Receipts** - 2 copies of the Acknowledgement of Receipt.

There have been 14 states that have franchise registration and disclosure laws modeled after or deferring to the North American Securities Administrators Association, Inc. ("NASAA") 2008 Franchise Registration and Disclosure Guidelines known as the Franchise Filing States. Over the years, a few states have changed their laws from registration to notice only reducing the number of full registration states to 10:

California	New York
Hawaii	North Dakota
Illinois	Rhode Island
Indiana (notice filing)	South Dakota (notice filing)
Maryland	Virginia
Michigan (notice filing)	Washington
Minnesota	Wisconsin (notice filing)

These states' laws generally apply to all sales of franchises to be located in the state (regardless of the residency of the franchisee) and to all residents of the states (regardless of the location of the franchise business). In these states a franchisor must register its FDD and receive approval from the state before it can offer franchises. These states accept the FDD format with certain additional

requirements to comply with the state's franchise practices act. In New York the FDD must be called an "Offering Prospectus."

EXEMPTIONS AND EXCLUSIONS TO STATE DISCLOSURE AND REGISTRATION LAWS

Under the various state disclosure and registration laws, there are exemptions and exclusions, but not always similar to the FTC Franchise Rule's exemptions and exclusions. For example, several states have a "large franchisor" (over \$5,000,000 net worth) exemption. Only 3 states, California, Illinois and Minnesota have a "fractional franchise" exemption. Several states have a minimal payment of less than \$500. Consequently, even if an exemption or exclusion is available under the FTC Franchise Law, the laws of the state where the prospective franchisee is a resident and the state where the franchised business is to located must also be examined.

STATE FRANCHISE RELATIONSHIP LAWS

Twenty-two states have laws that regulate to some extent the relationship between a franchisor and a franchisee in a general franchise relationship:

Arkansas	Michigan
California	Minnesota
Connecticut	Mississippi
Delaware	Missouri
Florida	Nebraska
Hawaii	New Jersey
Illinois	North Dakota
Indiana	South Dakota
Iowa	Virginia
Kentucky	Washington
Maryland	Wisconsin

The following list sets forth examples of franchisor conduct that is prohibited by one or more of these state statutes (no single state has all of these prohibitions):

- Imposition of unreasonable and arbitrary standards of conduct;
- Prohibitions against the right of free association among franchisees;
- Refusal to deal with franchisees in a commercially reasonable manner and in good faith;
- Discrimination among franchisees;
- Establishment of a company-owned or franchise business at a location within the franchisee's exclusive territory;
- Requirement that a franchisee consent to a release, assignment, novation, waiver, or estoppel at the time of entering into a franchise agreement;

- Termination of and failure to renew a franchise without adequate notice and good cause;
- Requirements that a franchisor repurchase certain items from a franchisee upon termination or nonrenewal;
- Restrictions on the sale or transfer of a franchise;
- Requirement that a franchisee purchase or lease goods or services from designated sources;
- Receipt of consideration from a person with whom the franchisees do business, which consideration is directly related to purchases from that person;
- Enforcement of unreasonable covenants not to compete;
- Entry into franchise agreements with terms of inadequate length;
- Modification of franchise agreements by franchisors without the consent of franchisees;
- Prohibition on change in management of any franchisee;
- Nonuse, for the franchisee's benefit, of fees collected for an advertising fund;
- Requirement that a franchisee waive the right to trial or consent to liquidated damages, termination penalties, or judgment notes;
- Misrepresentations of a franchisee's chances for success; and
- Requirements that a franchisee pay a security deposit.

Summary of Franchise Regulation by State

<u>STATE</u>	<u>REGISTRATION REQUIREMENT</u>	<u>RELATIONSHIP LAW</u>
Alabama	No	No
Alaska	No	No
Arizona	No	No
Arkansas	No	No
California ²	Yes	Yes
Colorado	No	No
Connecticut ¹	No	No
Delaware	No	No
Florida ¹	No	No
Georgia	No	No
Hawaii ¹	Yes	Yes
Idaho	No	No

Illinois ¹	Yes	Yes
Indiana ²	Yes	Yes
Iowa	No	No
Kansas	No	No
Kentucky	No	No
Louisiana	No	No
Maine	No	No
Maryland ¹	Yes	Yes
Massachusetts	No	No
Michigan ¹	Yes	Yes
Minnesota ¹	Yes	Yes
Mississippi	No	No
Missouri	No	No
Montana	No	No
Nebraska	No	No
Nevada	No	No
New Hampshire	No	No
New Jersey	No	No
New Mexico	No	No
New York ²	Yes	Yes
North Carolina	No	No
North Dakota ²	Yes	Yes
Ohio	No	No
Oklahoma	No	No
Oregon ¹	No	No
Pennsylvania	No	No
Rhode Island ²	Yes	No
South Carolina	No	No
South Dakota ²	Yes	Yes
Tennessee	No	No
Texas	No	No
Utah	No	No
Vermont	No	No
Virginia ¹	Yes	Yes
Washington ²	Yes	Yes
West Virginia	No	No
Wisconsin ¹	Yes	Yes
Wyoming	No	No
District of Columbia	No	No

¹ States with franchise statutes regulating disclosure

² States with exemptions to disclosure that may apply

IV. INFORMATION CONTAINED IN A FRANCHISE DISCLOSURE DOCUMENT

As mentioned in Part II, the FTC Franchise Rule requires a franchisor to give a Franchise Disclosure Document (FDD) to a prospective franchisee at least 14 days before the prospective franchisee can give the franchisor any money or sign any agreements. The completed franchise agreement with all the blanks filled must be given to a prospective franchisee at least 7 days before the prospective franchisee can give the franchisor any money or sign any agreements.

The purpose of this Franchise Disclosure Document is to give a prospective franchisee all material information about the franchise offering before he or she buys so that he or she can make an intelligent and fully informed investment decision by understanding their economic commitments and to develop a business plan. This section discusses the specific information that must be disclosed by the franchisor in a FDD on an item-by-item basis.

1. FTC Cover Page.

There must be included as page one the FTC Cover Page the following notice in not less than 11 point size print:

- (a) The title "**FRANCHISE DISCLOSURE DOCUMENT**" in capital letters and bold type.
- (b) The franchisor's name, type of business organization, principal business address, telephone number, and, if applicable, email address and primary home page address.
- (c) A sample of the primary business trademark that the franchisee will use in its business.
- (d) A brief description of the franchised business.
- (e) The following statements:
 - (1) The total investment necessary to begin operation of a [franchise system name] franchise is \$____ (the total amount of Item 7). This includes \$____ (the total amount in Item 5) that must be paid to the franchisor or affiliate.
 - (2) This disclosure document summarizes certain provisions of your franchise agreement and other information in plain English. Read this disclosure document and all accompanying agreements carefully. You must receive this disclosure document at least 14 calendar-days before you sign a binding agreement with, or make any payment to, the franchisor or an affiliate in connection with the proposed franchise sale. [The following sentence in bold type] **Note, however, that no governmental agency has verified the information contained in this document.**
 - (3) The terms of your contract will govern your franchise relationship. Don't rely on the disclosure document alone to understand your contract. Read all of your contract carefully. Show your contract and this disclosure document to an advisor, like a lawyer or an accountant.
 - (4) Buying a franchise is a complex investment. The information in this disclosure document can help you make up your mind. More information on franchising, such as "A Consumer's Guide to Buying a Franchise," which can help you understand how to use this

disclosure document, is available from the Federal Trade Commission. You can contact the FTC at 1-877-FTC-HELP or by writing to the FTC at 600 Pennsylvania Avenue, NW, Washington, D.C. 20580. You can also visit the FTC's home page at www.ftc.gov for additional information. Call your state agency or visit your public library for other sources of information on franchising.

(5) There may also be laws on franchising in your state. Ask your state agencies about them.

(6) [The issuance date].

(f) A franchisor may include the following statement between the statements set out at paragraphs (e)(2) and (3) of this section: "You may wish to receive your disclosure document in another format that is more convenient for you. To discuss the availability of disclosures in different formats, contact [name or office] at [address] and [telephone number]."

(g) Franchisors may include additional disclosures on the cover page, on a separate cover page, or addendum to comply with state pre-sale disclosure laws.

2. State Cover Page

The state cover page of the Franchise Disclosure Document must state:

STATE COVER PAGE

Your state may have a franchise law that requires a franchisor to register or file with a state franchise administrator before offering or selling in your state. REGISTRATION OF A FRANCHISE BY A STATE DOES NOT MEAN THAT THE STATE RECOMMENDS OR HAS VERIFIED THE INFORMATION IN THIS FRANCHISE DISCLOSURE DOCUMENT.

Call the state franchise administrator listed in Exhibit __ for information about the franchisor or about franchising in your state.

MANY FRANCHISE AGREEMENTS DO NOT ALLOW YOU TO RENEW UNCONDITIONALLY AFTER THE INITIAL TERM EXPIRES. YOU MAY HAVE TO SIGN A NEW AGREEMENT WITH DIFFERENT TERMS AND CONDITIONS IN ORDER TO CONTINUE TO OPERATE YOUR BUSINESS. BEFORE YOU BUY, CONSIDER WHAT RIGHTS YOU HAVE TO RENEW YOUR FRANCHISE, IF ANY, AND WHAT TERMS YOU MIGHT HAVE TO ACCEPT IN ORDER TO RENEW.

Please consider the following RISK FACTORS before you buy this franchise:

1. THE FRANCHISE AGREEMENT REQUIRES YOU TO RESOLVE DISPUTES WITH US BY ARBITRATION ONLY IN _____ COUNTY, _____. OUT OF STATE ARBITRATION MAY FORCE YOU TO ACCEPT A LESS FAVORABLE SETTLEMENT FOR DISPUTES. IT MAY ALSO COST YOU MORE TO ARBITRATE WITH US IN ____ THAN IN YOUR OWN STATE.

2. THE FRANCHISE AGREEMENT REQUIRES THAT _____ LAW GOVERNS THE AGREEMENT, AND THIS LAW MAY NOT PROVIDE THE SAME PROTECTIONS AND BENEFITS AS LOCAL LAW. YOU MAY WANT TO COMPARE THESE LAWS.

3. THERE MAYBE OTHER RISKS CONCERNING THIS FRANCHISE.

We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A franchise broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should make sure to do your own investigation of the franchise.

Effective Date: See the next page for state effective dates.

STATE EFFECTIVE DATES

The following states require that the Franchise Disclosure Document be registered or filed with the state, or be exempt from registration: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

This Franchise Disclosure Document is registered, on file or exempt from registration in the following states having franchise registration and disclosure laws, with the following effective dates:

<u>State</u>	<u>Effective Date</u>
California	
Hawaii	
Illinois	
Indiana	
Maryland	
Michigan	
Minnesota	
New York	
North Dakota	
Rhode Island	
South Dakota	
Virginia	
Washington	
Wisconsin	

In all the other states, the effective date of this Franchise Disclosure Document is the issuance date of _____.

Each registration state has its own special requirements such as Risk Factors or the name of the state agency that must also be included in the state cover page for that particular state.

3. Table of Contents

The table of contents must refer to the FDD items and state the page where each FDD item disclosure begins. The exhibits are then listed by letter.

ITEM 1: THE FRANCHISOR AND ANY PARENTS, PREDECESSORS, AND AFFILIATES

Item 1 of the amended Rule requires franchisors to disclose background information on the franchisor and any parents, predecessors, and affiliates.

Franchisor Disclosures

The term “franchisor” means any person who both grants a franchise and participates in the franchise relationship post-sale. This includes any subfranchisor that acts as a franchisor, engaging in pre-sale activities and having post-sale performance obligations. Item 1 also requires disclosure of the type of business organization used by the franchisor – whether a corporation, partnership, or any other business organization, such as a limited liability company.

Agent for Service of Process Disclosure

Item 1 requires franchisors both to identify the agent and to state the agent’s principal business address.

Parent Disclosures

Item 1 of the amended Rule differs from the UFOC Guidelines by requiring franchisors to identify any parent companies. Under the amended Rule, a “parent” means “an entity that controls another entity directly, or indirectly through one or more subsidiaries.” The term includes all parents in the chain of ownership, not just the immediate parent-owner of the franchisor, and not just the “ultimate” or “highest” parent in a chain of ownership. Item 1 does not call for the kind of detailed information about parents that it requires for affiliates and predecessors – their business background, their length of time selling franchises, or their involvement in other lines of business.

Predecessor Disclosures

The amended Rule requires the disclosure of any predecessor during the prior 10-year period immediately preceding the close of the franchisor’s most recent fiscal year. The amended Rule defines a predecessor as a person from whom the franchisor acquired, directly or indirectly, the major portion of the franchisor’s assets.

A change in ownership of a franchisor alone does not necessarily mean that the franchisor under the former ownership will be considered the “predecessor” of the franchisor under the new ownership. The former ownership must be disclosed as a predecessor only if the new ownership has acquired the majority of the franchisor’s assets from the former ownership, calculated as of the date of the acquisition of those assets. Further, implicit in the definition of “predecessor” is the requirement that the franchisor purchased operating assets from the predecessor entity *and* that the predecessor itself operated or franchised the same or a similar business. In short, the mere purchase by a franchisor of another entity’s assets by itself does not make the selling entity a predecessor.

Principal Business Address Disclosure

Item 1 calls for the disclosure of the principal business address of the franchisor, parent, predecessor, and affiliates. The definition of the term “principal business address” refers to the

physical address of the home office in the United States. The term excludes post office boxes, private mail drops, such as UPS Store private boxes, and email addresses.

Applicable Government Regulations Disclosure

Item 1 calls for the disclosure of any laws that apply to the franchised business specifically. Laws that pertain to all businesses generally – such as child labor laws, local signage restrictions, no-fault liability insurance requirements, business licensing laws, and tax regulations – need not be disclosed, even if those laws have a substantial or disproportionate impact on the business being offered for sale. Only laws that pertain solely and directly to the industry in which the franchised business is a part must be disclosed in Item 1. Where industry-specific laws are disclosed, statutory citation and identification are unnecessary. The disclosure should simply state that a specific type of regulation exists and that prospective franchisees should investigate the matter further.

ITEM 2: BUSINESS EXPERIENCE

Item 2 requires disclosure of the business experience of certain individuals – including directors and principal officers, among others – for the last 5 years. A longer period is acceptable if the prior experience is directly relevant to the franchises being offered for sale. Franchisors need not disclose information about the business experience of any broker that may be involved in sales of its franchises. In addition to disclosing the business background of directors and principal officers, franchisors must disclose the business experience of any individuals – even if they do not have a formal title – who have management responsibility relating to the sale or operation of franchises offered by the disclosure document. It does not matter whether the individuals with management responsibility are employed by the franchisor, an affiliate, or by a parent company. As long as the individual actively manages the sale of franchises or the operation of franchises, that individual's business experience should be noted in the Item 2 disclosure. Sales and operations managers, regardless of whether they have a formal title, should be disclosed if their involvement in either sales or operations is such that a prospective franchisee would rely on their expertise, formulation of policy, or control of the system in making an investment decision.

ITEM 3: LITIGATION

Item 3 requires the disclosure of certain lawsuits involving the franchisor and other entities associated with the franchisor – i.e., predecessors, parents, and affiliates – in addition to certain lawsuits involving any person identified in Item 2. Franchisors now must disclose suits that they initiate against franchisees, as explained below. In preparing an Item 3 disclosure, franchisors must consider two preliminary issues: (1) what types of litigation must be disclosed; and (2) whose litigation must be disclosed.

What Types of Litigation must Be Disclosed?

Under the amended Franchise Rule, certain suits falling into 4 broad categories must be disclosed in Item 3: pending lawsuits, lawsuits involving the franchise relationship, prior lawsuits, and current government injunctive or restrictive actions. These include arbitrations. Ordinarily, mediations need not be disclosed, unless the mediation results in the settlement of an ongoing lawsuit that must be disclosed in Item 3. It also includes material foreign litigation, even if the actions are in a foreign court or arbitration forum.

Pending Actions

Two types of pending lawsuits must be disclosed. The first type consists of any administrative, criminal, or material civil action that alleges a violation of a franchise, antitrust, or securities law, or that alleges fraud, unfair or deceptive practices, or comparable allegations. A “material” civil action is one that is likely to influence a prospective franchisee’s investment decision. Accordingly, a franchisor must disclose pending suits such as those filed by the Federal Trade Commission or United States Department of Justice against a franchisor for violations of the Franchise Rule (or other Commission trade regulation rules) or deceptive or unfair trade practices in violation of Section 5 of the FTC Act. It also includes state actions, such as those filed by a state Attorney General. Second, the franchisor must disclose whether it, any related entity or any person identified in Item 2 has been involved in any pending civil lawsuits, “other than ordinary routine litigation incidental to the business, which are material in the context of the number of franchisees and the size, nature, or financial condition of the franchise system or its business operations.” These factors must be weighed on a case-by-case basis to determine whether any particular civil action is material and therefore must be disclosed.

Material Actions Involving the Franchise Relationship

The franchisor must disclose whether it, any related entity or any person identified in Item 2 has been a party to any material civil actions involving the franchise relationship in the last fiscal year. Material franchisor-initiated suits – those likely to influence a prospective franchisee’s investment decision – must be disclosed. All suits pertaining to the franchise relationship – even a small number of suits – are presumed to be material because they may shed light on problems in the franchise relationship or the likelihood that the franchisor will resort to litigation against a franchisee. Only suits filed over the course of the last fiscal year must be disclosed. Franchisors need only prepare this disclosure on an annual basis and disclose only those suits filed (not pending) during the previous fiscal year. Franchisors that begin franchising in the middle of their fiscal year, or that first initiate a lawsuit against a franchisee in the middle of their fiscal year, need only update their documents to disclose franchisor-initiated suits upon the close of their current fiscal year, as part of their annual update.

Only suits involving the “franchise relationship” must be disclosed. These suits involve contractual obligations between the franchisor and franchisee, arising directly from the operation of the franchised business. The “franchise relationship” limitation specifically excludes actions involving third parties, such as suits by a franchisor against a supplier. It also excludes suits initiated by a franchisor against a franchisee for indemnification of tort liability. Franchisors disclosing franchisor-initiated litigation may utilize streamlined reporting. While franchisors reporting franchisor-initiated litigation may disclose full case citations and summaries, they may comply with the amended Rule, if they wish, by listing individual suits (by name with citation) under one common heading that serves as a summary. For example, the franchisor may list individual cases under common headings such as “royalty collection suits,” and “system standards.”

Prior Actions

The franchisor must disclose whether it, any related entity or any person identified in Item 2 has been involved in certain types of legal actions within 10 years before the issuance date of the FDD. Specifically, any convictions or *nolo contendere* pleas to a felony charge must be disclosed, as well as civil actions in which the franchisor was held liable involving alleged violations of “a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive practices, or

comparable allegations.” For purposes of this disclosure, a party is “held liable” if that party must pay money or other consideration, must reduce an indebtedness by the amount of an award, cannot enforce its rights, or must take action adverse to its interests. Accordingly, dismissals, including a dismissal concluding an adversarial proceeding, need not be disclosed. If a formal settlement agreement must be disclosed, then all material terms of the settlement must be disclosed, regardless of whether the agreement is confidential. However, franchisors need not disclose the terms of any confidential settlements entered into before the franchisor began franchise sales.

Injunctive Actions

The franchisor must disclose whether it, any related entity or any person identified in Item 2 is subject to a currently effective injunctive or restrictive order or decree resulting from a pending or concluded action brought by a governmental agency – such as the FTC, SEC, or state Attorney General – under a federal, state, or Canadian franchise, securities, antitrust, trade regulation, or trade practice law, or that otherwise relates to the franchise. An injunctive or restrictive order or decree is “currently effective” unless it has (1) been vacated or rescinded by a court or by the issuing agency, or (2) expired by its own terms. If the named parties have fully complied with an order requiring a specific course of action – such as registering its disclosure document – then the order is no longer “currently effective.”

Whose Litigation must Be Disclosed?

Item 3 calls for different disclosures depending upon the entity involved in the suit. Whenever a franchisor or predecessor has been involved in one of the 4 categories of litigation covered in Item 3, that suit must be disclosed. If a franchisor’s predecessor is no longer affiliated with the franchisor, the franchisor must make a good faith effort to obtain updates about the predecessor’s prior and current litigation. If unable to do so, the franchisor can note that fact in Item 3. A parent’s litigation must be disclosed only if the parent promises “to back the franchisor financially or otherwise guarantees the franchisor’s performance.” Generally, this means that parent litigation must be disclosed when the parent promises to ensure the franchisor’s post-sale performance either by providing needed funds to the franchisor or by fulfilling the franchisor’s post-sale obligations on behalf of the franchisor. Affiliate litigation must be disclosed if the affiliate offers franchises under the franchisor’s principal trademark, or if the affiliate promises “to back the franchisor financially or otherwise guarantees the franchisor’s performance.” A franchisor must also disclose currently effective injunctions, decrees, and orders resulting from government legal actions against an affiliate if the affiliate “has offered or sold franchises in any line of business within the last 10 years.”

ITEM 4: BANKRUPTCY

Franchisors must disclose not only the bankruptcy history of the franchisor itself, its affiliates, and predecessors, but also of any of its parents. Bankruptcy history must be disclosed for *all* affiliates and parents: any bankruptcy in which an affiliate or a parent was involved during the 10-year reporting period immediately before the issuance date of the disclosure document must be disclosed. In addition, franchisors must disclose bankruptcies involving any officer or general partner of the franchisor, and “any other individual who will have management responsibility relating to the sale or operation of franchises offered” by the disclosure document, including those of any company of which they were a principal officer or general partner.

ITEM 5: INITIAL FEES

Item 5 of the amended Rule requires the disclosure of any initial fees and any conditions on their refundability. “Initial fees” means “all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee’s business opens, whether payable in lump sum or installments.”

Uniformity of Fees Disclosure

In some instances, franchisors do not charge the same initial fees to every prospective franchisee. Where fees are not uniform, franchisors have a choice. They can disclose a range of fees paid in the last year. For example, fees may have varied over time because of increases in costs. In such instances, a range of fees is acceptable. In the alternative, franchisors can disclose the formula used to calculate the initial fees paid in the last fiscal year, along with any factors other than the formula itself that determined the fee amount. For example, franchisors may calculate initial fees based on a dollar amount per number of potential consumers in the prospective franchisees’ territory.

Refunds

Item 5 requires a disclosure about the refundability of initial fees. Franchisors are not required to refund initial fees paid by prospective franchisees. Nevertheless, if the initial fees are refundable in whole or part, the franchisor must state the terms and conditions under which a refund can be obtained.

Installment Payments

Finally, if any initial fees may be paid on an installment basis, Item 5 requires a disclosure of the installment payment terms. Thus, where the initial fees include payments for goods, equipment, or other items on an installment basis, the franchisor must disclose the payment terms. The amended Rule makes clear that franchisors have the option of disclosing installment payment terms either in Item 5 or in Item 10 (the financing section) of the disclosure document.

ITEM 6: OTHER FEES

Item 6 of the amended Rule requires the disclosure, in a prescribed tabular format, of recurring or occasional fees associated with operating a franchised outlet. These recurring or occasional fees include such charges as royalties, advertising fees, and transfer fees. Item 6 covers payments made directly to the franchisor or an affiliate, or collected by the franchisor or affiliate for the benefit of a third party. It does not include payments made directly by a franchisee to third parties, such as fees for telephone and Internet service. Although fees paid directly to third parties need not be disclosed in Item 6, they typically must be disclosed in Item 7 or 8. Franchisors must state each type of fee, the amount of the fee, and the due date. Any formula used to compute the fee must be disclosed as well. If a fee may increase, franchisors must disclose the maximum amount of the increase or the formula used to determine the increase. For example, a percentage of gross sales is an acceptable formula, provided the franchisor defines what it means by “gross sales.” Any remarks, definitions, caveats or other information that is necessary to clarify the fees disclosed can be made in the remarks column in the table, or, if the remarks are long, in footnotes to the table. The remarks column (or footnote) must address, if applicable: (1) whether the fee is payable only to the franchisor; (2) whether the fee is imposed and collected by the franchisor; (3) whether the fee is non-refundable

or the circumstances when the fee is refundable; (4) whether the fee is uniformly imposed; and (5) the voting power of franchisor-owned outlets on any fee imposed by cooperatives. If the franchisor-owned outlets have controlling voting power, then the franchisor must disclose the maximum and minimum fee that may be imposed. For Item 6 purposes, franchisors need only disclose whether the current fee is uniformly imposed and collected by the franchisor.

ITEM 7: ESTIMATED INITIAL INVESTMENT

Item 7 of the amended Rule requires franchisors to set out in a prescribed tabular format a franchisee's entire estimated initial investment – *i.e.*, all the expenses required by the franchise agreement and all other costs necessary for a franchisee to commence business. These expenses include items that are often paid to third parties, such as rent, equipment, and inventory. Item 7 does not prescribe an exhaustive list of the types of fees or expenses that must be included in the table. The number and types of fees will necessarily vary depending upon the nature of the franchised business. However, Item 7 does list expenses that are typical, such as the initial franchise fee; training expenses; real property (whether purchased or leased); equipment; beginning inventory; and business licenses and related fees. In addition to these typical expenses, franchisors must itemize and identify any other specific required payments such as additional training, travel, and advertising expenses that franchisees will incur to begin operations.

Most of the expenses to be disclosed in Item 7 cover only the period prior to the date the franchise opens. Item 7, however, also requires franchisors to include in the table a category called “Additional funds - [initial period].” In this part of the chart, franchisors must list any other required expenses that franchisees will incur both before operations begin and during “the initial period” of operations. The listing of expenses in Item 7 – including the listing of expenses during the “initial period” alone – does not constitute a financial performance representation that will trigger an Item 19 disclosure. Under the amended Rule, the definition of “financial performance claim” has been revised to eliminate coverage of costs or expenses standing alone. Accordingly, the listing of expenses in Item 7 alone does not trigger any Item 19 disclosure obligation. The “initial period” of operations may vary from franchisor to franchisor. In general, a reasonable period is at least three months. Franchisors may use a longer period that is reasonable for the industry. Franchisors must disclose the specific initial period used, and describe the factors, basis, and experience they considered or relied upon to calculate their estimate of “additional funds.” Note that the “initial period” requirement covers only the “additional funds” item in the Item 7 chart. The other items in the chart pertain only to the period up to the date the franchised outlet opens for business. For each item listed in the Item 7 chart, franchisors must disclose:

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- the amount of the payment;
- the method of payment;
- when the payment is due; and
- to whom the payment is to be made.

If the amount of a payment is unknown, then franchisors may use a low-high range based upon the franchisor's current experience. For real estate costs that cannot be estimated by a low-high range, franchisors may describe the approximate size of the property and building, and the probable location of the building (*e.g.*, strip shopping center, mall, downtown, rural, or highway). Item 7 requires franchisors to state, in footnotes, whether each payment is non-refundable, or the circumstances when the payment is refundable. In addition, if the franchisor (or affiliate) finances part of the initial investment, the amount financed, the required down payment, the annual interest rate, rate factors, and the estimated loan repayments must be disclosed. The amended Rule permits

franchisors to refer to Item 10 (financing) for additional details. The additional funds item line generally does not include a franchise owner's salary or draw.

ITEM 8: RESTRICTIONS ON SOURCES OF PRODUCTS AND SERVICES

Item 8 of the amended Rule requires the disclosure of obligatory purchases, restrictions on sources of products and services, and the amount of any revenue franchisors may receive from required suppliers. It also requires the disclosure of purchasing or distribution cooperatives.

Required Purchases of Goods and Services

Item 8 requires the disclosure of any obligation on the part of franchisees to purchase or lease goods, services, or supplies from specific suppliers in the establishment or operation of the franchised business. These purchases include fixtures, equipment, inventory, computer hardware and software, real estate, and any other purchase necessary to establish or operate the franchised business. Required purchases can be supplied by the franchisor, its designee, suppliers approved by the franchisor, or suppliers with products that meet the franchisor's specifications. The obligation to purchase the items may be imposed by the franchise agreement or by the franchisor's actual practice, such as requirements in the franchisor's operating manual. Franchisors may explain in Item 8 the reason for any particular purchase requirement. Item 8 need not include the purchase or lease of goods or services that are already provided to franchisees as part of the initial franchise fee, such as initial training, which have been disclosed in Item 5. Similarly, fees disclosed in Item 6 need not be repeated in Item 8.

Optional Purchases

Item 8 covers only required purchases and leases of goods and services that are source-restricted, meaning that the franchisee must make the purchases from a specific supplier or limited group of suppliers. This may include purchases or leases from the franchisor or the franchisor's affiliate if the franchisor or its affiliate is the only (or one of the only) approved suppliers, or its products are the only (or among the only) ones that meet the required specifications. Where franchisees have total discretion to purchase or lease items from any source, but elect to purchase them from the franchisor, such purchases need not be disclosed in Item 8.

Approval of Alternative Suppliers

For each required purchase, Item 8 requires franchisors to disclose whether and, if so, how it may grant franchisees the right to use alternative suppliers. Specifically, the franchisor must disclose:

- Whether the franchisor's criteria for approving suppliers are available to franchisees;
- Whether the franchisor permits franchisees to contract with alternative suppliers who meet the franchisor's criteria;
- Any fees and procedures necessary to secure approval from the franchisor to purchase from alternative suppliers;
- The time period in which the franchisor will notify the franchisee of approval or disapproval of an alternative supplier;

- How approvals are revoked; and
- Whether the franchisor issues specifications for goods or services and, if so, how the franchisor may modify the specifications.

Ownership Interest in a Supplier

Item 8 requires franchisors to disclose whether any officer of the franchisor owns an interest in a required supplier. For purposes of this disclosure, an “officer” is any person with management or policy-making authority. The term “an interest” is to be read broadly to include any percentage of direct ownership from which the officer derives income or other financial benefits. Accordingly, it includes ownership of stock in the supplier-company.

Revenue Derived from a “Supplier”

Item 8 requires disclosure of whether the franchisor or any of its affiliates will or may receive revenue or other material benefits from required purchases or leases by franchisees from the franchisor, its affiliates, or a third-party supplier. The term “supplier” is intended to capture all third parties in the manufacturing and distribution chain who may make payments to the franchisor or any of its affiliates when their goods are sold to franchisees.

Payments to Third Parties

If suppliers make payments to an advertising fund or a trademark-specific franchisee association, or any other third party controlled directly or indirectly by the franchisor or an affiliate, such payments must be reported in Item 8. On the other hand, where payments are made to independent third parties, such as an independent advertising co-op, disclosure is not required.

Benefits

Any payment or benefit that a franchisor may receive as a result of franchisee purchases must be disclosed in Item 8. For example, if, as a result of requiring franchisees to use a specific supplier, the franchisor receives a “special deal” or “volume discount” from that supplier benefitting company-owned outlets, but not franchised outlets, this benefit must be disclosed.

Extent of Required Payments

Item 8 requires a description of the “precise basis” upon which the franchisor or its affiliates may derive revenues or other benefits from suppliers. This description must include a statement of:

- The franchisor’s total revenue;
- The franchisor’s revenues from all required purchases and leases of products and services by franchisees;
- The percentage of the franchisor’s total revenues that comes from purchases or leases required by the franchisor;
- The revenues received by affiliates of the franchisor from purchases or leases required

by the franchisor; and

- The estimated portion of the franchisee's required purchases and leases to all purchases and leases by the franchisee in establishing and operating the franchise.

The total revenue calculation should be taken from the franchisor's statement of operations (or profit and loss statement) from the most recent annual audited financial statement attached to the FDD. Where the franchisor or an affiliate does not have audited financial statements, the franchisor should disclose the sources of financial information it used to compute its own or an affiliate's revenues.

Aggregate Reporting

Payments to franchisors from suppliers may be disclosed either as a percentage or as a flat dollar figure on an aggregate, not individual supplier, basis. For example, one supplier may make payments of 1% or a flat payment of \$1,000, while another may make payments of 5% or \$5,000. In such circumstances, the franchisor should disclose receiving payments ranging from 1% - 5% or, if it uses the flat-fee alternative, \$1,000 to \$5,000. A "payment" for this purpose includes the sale of similar goods or services to the franchisor at a lower price than to franchisees.

Cooperatives

Item 8 calls for the disclosure of any purchasing or distribution cooperatives. If a franchisee is required to participate in a purchasing or distribution cooperative, then the franchisor must identify the cooperative. If participation is voluntary, the franchisor need not identify the cooperative, but it should disclose that one or more of these cooperatives exist.

Negotiated Prices

Item 8 requires franchisors to disclose whether they negotiate purchase agreements with suppliers, including price terms, for the benefit of franchisees. However, the specific price terms negotiated need not be disclosed.

ITEM 9: FRANCHISEE'S OBLIGATIONS

Item 9 of the amended Rule requires the disclosure of a franchisee's principal obligations in the prescribed tabular format that references the franchise agreement or other relevant contracts, and the disclosure document sections where more information about the particular obligation can be found. If a particular obligation is not applicable, franchisors should simply state "Not Applicable" at that place in the chart. Franchisors should include additional obligations, as may be warranted for their particular franchise system, in the "other" section of the chart.

ITEM 10: FINANCING

Item 10 of the amended Rule requires franchisors to disclose all material terms and conditions of any financing arrangements. The required disclosures include:

- The rate of interest, plus finance charges, expressed on an annual basis;

- The number of payments;
- Penalties upon default; and
- Any consideration received by the franchisor for referring a prospective franchisee to a lender.

Franchisors may use the tabular format set forth in the Rule to summarize the financing arrangement, but that format is not required. Disclosure of financing terms and conditions in Item 10 does not prevent the parties from negotiating different terms and conditions after the disclosure. Prospective franchisees will have 7 days to review any changes in financing terms or conditions if the changes were made unilaterally by the franchisor, because such changes in financing terms or conditions are presumptively material to the franchisee’s purchasing decision.

Financing Agreements

For purposes of Item 10, the term “financing agreement” includes any “leases and installment contracts . . . that the franchisor, its agent, or affiliates offer directly or indirectly to the franchisee.” Indirect offers of financing include a written arrangement between a franchisor or its affiliates and a lender, where the lender offers financing to a franchisee. It also includes instances where a franchisor or an affiliate receives a benefit from a lender in exchange for financing a franchise purchase, as well as instances where the franchisor guarantees a note, lease, or other obligation of the franchisee. If the franchisor or an affiliate receives a benefit from the lender, the franchisor must disclose the amount or method of determining the payment, the source of the payment, and the relationship of the source to the franchisor or its affiliate. Sample copies of any financing agreements must be included in Item 22.

Interest Rate

Franchisors offering financing must disclose the rate of interest, plus finance charges, expressed on an annual basis, consistent with consumer credit transactions. Franchisors may look to the Truth in Lending and Consumer Leasing regulations for guidance in preparing their Item 10 interest rate disclosures.

Variable Rates

Interest rates or finance charges may fluctuate between the time when the prospective purchaser receives the FDD and the time when he or she actually executes the financing agreement. The amended Rule provides disclosure of what the rate of interest, plus finance charges, expressed on an annual basis, was on a specified recent date. A franchisor may include a footnote stating that the interest rate may vary or state a formula by which the rate may change until the financing agreement is signed. Where the rate may change during the life of the loan, disclosure of that fact is required under the Item 10 “catch-all” requirement, which calls for disclosure of “other material financing terms.”

ITEM 11: FRANCHISOR’S ASSISTANCE, ADVERTISING, COMPUTER SYSTEMS, AND TRAINING

Item 11 of the amended Rule requires the disclosure of the franchisor’s obligations under the franchise agreement to furnish assistance to franchisees. The disclosure requirements encompass

pre-opening assistance (e.g., site selection), as well as any ongoing assistance, such as advertising and training, during the operation of the franchise.

The amended Rule's Item 11 requires less detailed disclosures about computer system requirements than did the corresponding item in the UFOC Guidelines. The amended Rule's Item 11 also follows the UFOC Guidelines in requiring either disclosure of the franchisor's operating manual table of contents or access to the operating manual itself. For each assistance obligation disclosed in Item 11, franchisors must include a citation to the specific section number of the franchisee agreement that imposes the obligation on the franchisor.

Pre-Opening Assistance

After the standard statement about the franchisor's limited obligations to furnish assistance, the first disclosure topic under Item 11 is the franchisor's pre-opening obligations to the franchisee, including any site location assistance, such as, for example, negotiation of the purchase or lease of the site, site approval requirements, and the typical length of time it takes to open a franchise.

Continuing Assistance

Following disclosure of the franchisor's pre-opening assistance obligations, Item 11 requires disclosure of the franchisor's obligation to provide continuing assistance to the franchisee after the franchise is opened. Many different kinds of assistance must be disclosed, although the specifics will vary depending on the type of franchise.

Optional Assistance

Some franchisors provide pre-opening assistance or ongoing assistance after the opening of a franchise that they are not obligated by the franchise agreement to provide. Such assistance may be included in the Item 11 disclosure, provided that it is set out separately and clearly identified as assistance that is not required by the franchise agreement.

Advertising Assistance

The information required to be disclosed regarding advertising assistance includes, for example:

- whether the franchisor is obligated to conduct advertising;
- the media used for any advertising (e.g., print, radio, television, or Internet);
- the source of the advertising;
- the geographical scope of the advertising (i.e., local, regional, or national);
- whether franchisees must contribute to an advertising fund or spend any specified amount on advertising in their local area; and
- the role of any advertising councils or cooperatives and how they operate.

For any advertising fund to which a franchisee must contribute, Item 11 requires franchisors to disclose who contributes to the fund, whether other franchisees and franchisor-owned outlets contribute on the same basis, who administers the fund, whether the fund is audited, whether its financial statements are available for review, whether franchisees receive a periodic accounting of fund expenditures, and the percentage of the fund, if any, used principally to solicit new franchise sales.

Multiple Brand Advertising

If a franchisor offers more than one branded or trademarked franchise for sale, it should, as a general rule, segregate its disclosures for each brand. Nevertheless, it may be impractical or unreasonable for the franchisor to segregate advertising funds by brand. In such circumstances, a franchisor may aggregate its advertising fund disclosures across its brands, as long as the disclosure makes clear that the advertising funds are aggregated across brands.

Allocation of Production and Administrative Expenses

Item 11 requires franchisors to disclose the use of advertising funds in the last fiscal year, including percentages spent on production, media placement, administrative expenses, and other described expenses. A franchisor's internal costs associated with advertising production (*e.g.*, supplies, photography, and computer graphics) can be characterized as production expenses. The franchisor, however, must have a reasonable basis for claiming the allocation of production expenses at the time disclosure is made. Similarly, if an advertising fund pays all or part of the salaries of franchisor personnel who are involved in the advertising of the franchise system's products or services, those costs – if reasonable – can be considered a production or administrative expense if the allocation is explained in the Item 11.

Computer Systems

Item 11 of the UFOC Guidelines required franchisors to identify each component of hardware and software by brand, type, and principal function, or to identify compatible equivalents and whether they had been approved by the franchisor. By contrast, under the amended Rule, the franchisor need not identify each and every piece of hardware and software by brand, type, and principal function. Nor must the franchisor identify compatible equivalents and explain whether the franchisor has approved them. It is sufficient for franchisors to describe generally:

- the cash register or computer systems to be used, if any;
- any obligation of the franchisor, an affiliate, or third party to provide ongoing maintenance, repairs, upgrades, or updates;
- the cost of purchasing or leasing the system, and the annual cost of any optional or required maintenance, upgrades, or support contracts;
- any obligation of the franchisee to upgrade or update any such system, and any contractual limits on the frequency and cost of that obligation; and
- whether the franchisor will have access to information contained in those systems.

This information about required computer systems is designed to enable prospects to weigh the costs and benefits of purchasing a specific franchise. Further, it is designed to enable prospective franchisees to assess readily whether they may be at a technological advantage or disadvantage compared to franchisees of competing franchise systems. The amended Rule recognizes that start-up franchisors may be uncertain about which computer systems or software they will expect franchisees to use. Accordingly, Item 11 is flexible. In its Item 11 disclosures, a start-up franchisor may indicate that computer requirements are yet to be determined, if that is the case, or otherwise factually state its policy concerning computer usage. The fact that a start-up franchisor has not finalized its plans for electronic cash registers or computer systems is itself material information to disclose to prospective franchisees.

Operating Manuals

Item 11 requires franchisors to disclose the table of contents of the system's operating manual that franchisees receive, and certain other information about the manual, as of the end of the franchisor's last fiscal year or a more recent date. The table of contents of the operating manual can be included as one of the exhibits in Item 22 of the disclosure document. The operating manual table of contents need not be disclosed if the franchisor offers the prospective franchisee the opportunity to review the operating manual itself before buying the franchise. It is important to note that merely asking a prospective franchisee to first sign a confidentiality agreement before permitting access to the operating manual will not trigger the disclosure requirement of the amended Rule. While the signing of a confidentiality agreement is "in connection with the proposed franchise sale," it does not bind the prospective franchisee to purchase the franchise or to undertake other financial obligations, such as the signing of a lease. This assumes, however, that the confidentiality agreement contains no other agreements that, in the absence of the confidentiality agreement, would trigger the obligation to provide the disclosures required by the amended Rule.

Training

Finally, Item 11 requires franchisors to disclose their training program as of the end of their last fiscal year or a more recent date. Some of the training disclosures must be summarized in a table titled, in bold, capital letters, "**TRAINING PROGRAM.**" The table must include a listing of the subject matter of the training, the hours of classroom training on each subject, hours of on-the-job training, and the location of the training. Other required information – such as who may and who must attend training, whether successful completion of training is required, the charges for the training, if any, who pays for any travel and living expenses, and whether additional training or refresher course are required – may be disclosed after the table. The amended Rule's Item 11 also calls for disclosure of information about the staff that provides the training. If the franchisor's training staff is large or changes frequently, the franchisor can use a general description of the background and experience of the staff providing the training. Also, franchisors should disclose here (if not disclosed in Item 2) the corporate officer in charge of training, if any, along with information about his or her experience.

ITEM 12: TERRITORY

Item 12 of the amended Rule requires detailed disclosures concerning assigned territories and applicable sales restrictions. Two important topics that must be covered in Item 12, among others, are:

- the conditions, if any, under which a franchisor will approve the relocation of the franchisee’s business and the franchisee’s establishment of additional outlets; and
- any present plans on the part of the franchisor to operate a competing franchise system offering similar goods or services.

In addition, if a franchisor does not offer an exclusive territory, Item 12 requires the franchisor to include a prescribed statement underscoring that point, and warning about the consequences of purchasing a non-exclusive territory.

Item 12 also mandates disclosures on several other specific topics relating to territories. Disclosures about the impact of technological innovation and new market developments must be included here. Specifically, Item 12 requires disclosure of information about the use of the Internet to achieve sales and the use of alternative channels for distributing a franchisor’s goods. These disclosures are required regardless of whether the franchisor provides an exclusive territory. In this regard, Item 12 requires a franchisor to disclose whether, under the franchise agreement:

- the franchisor itself can solicit or accept orders from consumers within a franchisee’s territory;
- the franchisor reserves the right to use alternative channels of distribution within a franchisee’s territory, including Internet, catalog, or
- telemarketing sales; and
- any compensation a franchisor pays to a franchisee for soliciting or accepting orders from inside the franchisee’s territory.

Finally, Item 12 calls for disclosure of similar information describing the extent to which a franchisee will be restricted from soliciting or accepting orders from outside his or her territory, including whether a franchisee has the right to distribute through alternative channels, such as the Internet, catalog sales, telemarketing, or other direct marketing.

ITEM 13: TRADEMARKS

Item 13 of the amended Rule requires franchisors to disclose whether each of its principal trademarks is registered with the United States Patent and Trademark Office (“PTO”), as well as application, renewal, and other related information. If not, Item 13 mandates the following prescribed statement:

We do not have a federal registration for our principal trademark. Therefore, our trademark does not have as many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses.

Item 13 also calls for disclosure of other information, including:

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- the existence of any pending litigation, settlements, agreements, or superior rights that may limit a franchisee’s use of the trademark; and
- any contractual obligation of the franchisor to protect a franchisee’s right to use the principal trademarks, and to protect the franchisee against claims of infringement or unfair competition.

Item 13 mandates these disclosures because the existence of pending litigation, settlement restrictions, or other potential limitations on the use of the trademark is highly material information. These are all factors on which the value of the trademark to a prospective franchisee may depend. Any one of them ultimately could have a major impact on a franchisee’s ability to continue operating the franchise.

Item 13 permits a franchisor to include an attorney’s opinion regarding the merits of any litigation or of a PTO or similar action if the attorney issuing the opinion consents to its use. The text of the Item 13 disclosures may include a summary of the opinion if the full opinion is attached to Item 22 and the attorney issuing the opinion consents to the use of the summary.

ITEM 14: PATENTS, COPYRIGHTS, AND PROPRIETARY INFORMATION

Like Item 13, Item 14 of the amended Rule follows the UFOC Guidelines in requiring disclosure of information about intellectual property related to the franchise. Franchisors must disclose the types of intellectual property, their ownership rights or licenses in each, details about, and the duration of, their rights, and any legal proceedings, settlements, and restrictions that may impact the franchisee’s ability to use such property, among other things. Item 14 permits a franchisor to include an attorney’s opinion regarding the merits of litigation or of a PTO or similar action if the attorney issuing the opinion consents to its use. The text of the Item 14 disclosures may include a summary of the opinion if the full opinion is attached to Item 22 and the attorney issuing the opinion consents to the use of the summary.

ITEM 15: OBLIGATION TO PARTICIPATE IN THE ACTUAL OPERATION OF THE FRANCHISE BUSINESS

Item 15 of the amended Rule requires franchisors to disclose whether franchisees are required to participate personally in the direct operation of the franchise. Among other things, the amended Rule’s Item 15 calls for disclosures stating:

- any obligation for the franchisee to participate directly in the business that arises from the parties’ franchise agreement, **or** from any other agreement, **or** from the franchisor’s practice;
- whether the franchisor recommends direct participation; and
- if personal “on-premises” supervision is not required, any limitations on whom the franchisee can hire as a supervisor, whether the supervisor must successfully complete training, and any restrictions (*e.g.*, covenants not to compete or trade secrecy agreements) that the franchisee must place on his or her manager.

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- If the franchisee is not an individual but operates as a business entity – *e.g.*, a corporation or a partnership – Item 15 requires the franchisor to disclose the amount of equity interest, if any, that the on-premises supervisor must have in the franchise.

ITEM 16: RESTRICTIONS ON WHAT THE FRANCHISEE MAY SELL

The amended Rule’s Item 16 calls for disclosure of any restrictions relating to the goods or services a franchisee sells, including:

- any restriction allowing only sales of franchisor-approved goods or services;
- any restriction requiring a franchisee to sell all goods or services authorized by the franchisor; and
- whether the franchisor has the right to change the types of authorized goods or services and whether there are any restrictions on the franchisor’s right to make such changes.

ITEM 17: RENEWAL, TERMINATION, TRANSFER, AND DISPUTE RESOLUTION

Item 17 of the amended Rule requires franchisors to summarize, in the specified tabular format, common provisions of franchisee agreements, including those provisions dealing with termination, renewal, and dispute resolution.

Discretionary Benefits

If the franchise agreement is silent regarding one or more of the categories enumerated in the prescribed table, but the franchisor voluntarily offers to provide certain benefits or protections to franchisees as a matter of policy, then the franchisor may add a footnote to the table describing the policy and state whether the policy is subject to change. For example, if the franchisor routinely offers to buy back a franchised outlet upon the death of the franchisee-owner, that policy may be added as a footnote to the line in the table for “Death or Disability of Franchisee.”

Renewals

The amended Rule requires franchisors to explain their renewal policy in the “Summary” column of the line in the table titled “Requirements for Franchisee to Renew or Extend.” This requirement is designed to prevent prospective franchisees from being confused or misled about what is meant by the term “renewal” – a term that may be applied differently from one franchise system to another. For example, in many franchise systems, a right of renewal means that the franchisee, upon the expiration of the original term of the franchise agreement, has the right to enter into a new agreement according to the then-current terms and conditions. In other systems, the franchisee may have a simple right to extend the existing agreement under the same terms and conditions for an additional period of time. Regardless, the franchisor must explain in the summary column in the line titled “Requirements for the Franchisee to Renew or Extend” what the term means in its system. If the franchisor’s policy is that franchisees may be asked to sign the then-current agreement, then the franchisor must also include a statement alerting franchisees that the terms and conditions of the renewal contract may differ materially from those of their initial contract. Franchisors have the flexibility to include a statement of their choosing as long as it

conveys the idea that the renewal agreement may impose materially different terms and conditions than those in the original agreement.

ITEM 18: PUBLIC FIGURES

Item 18 of the amended Rule requires the disclosure of certain information about a public figure's involvement in the franchise system. This covers public figures lending their name or image to the franchise, control or manage the franchisor, or invest in the franchisor.

Who Qualifies as a "Public Figure"?

A public figure means a person whose name or physical appearance is generally known to the public in the geographic area where the franchise will be located. Typical public figures include sports stars, actors, musicians, and similar celebrities.

Use of Name, Image, or Endorsement

If a public figure's name is used as part of the franchisor's name, the public figure's image is used as a symbol associated with the franchise, or the public figure endorses or recommends the franchise to prospective franchisees, then the franchisor must disclose any compensation or other benefits given or promised to the public figure. Item 18 is limited to circumstances when a public figure's identification with a system is for the purpose of selling franchises. Merely using a public figure as a spokesperson to promote a system's products or services sold to consumers does not bring a franchisor within the ambit of the amended Rule's Item 18 requirements.

Management

If a public figure is involved in the management or control of the franchisor, the franchisor must disclose the extent of that involvement, including the public figure's position in the franchisor and his or her duties in the business structure.

Investment

If a public figure invests in the franchisor, the franchisor must disclose the type and total amount of his or her investment. The "type" of investment includes cash, stock, promissory notes, and any in-kind services performed or to be performed by the public figure.

ITEM 19: FINANCIAL PERFORMANCE REPRESENTATIONS

The amended Rule permits, but does not require, franchisors to include representations about financial performance in their disclosure documents. Unlike the original Rule, a franchisor that decides to make such representations must include them in Item 19, not in a separate document. A franchisor electing to make a financial performance representation must, among other things, have a reasonable basis and written substantiation for the representation at the time it is made, and disclose the bases and assumptions underlying the representation in Item 19. The Item 19 disclosures also must include an admonition that a prospective franchisee's actual earnings may differ. Franchisors should keep in mind not only the affirmative disclosure requirements in Item 19, but the parallel prohibitions against making representations that are not true or are not substantiated at the time they are made.

Required Item 19 Preambles

All Item 19 disclosures must begin with a prescribed preamble that informs prospective franchisees about the law of financial performance representations:

The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

This preamble must be included word-for-word as set out above, with no modification in language or punctuation.

If a franchisor elects not to make any financial performance representations, then the franchisor's disclosure document must include in Item 19 not only the universal preamble set out immediately above, but also the following additional preamble:

We do not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. 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.

Like the universal preamble, this preamble for those not making financial performance representations must be included word-for-word as set out above, with no modification in language or punctuation.

Note that franchisors that make no Item 19 financial performance representations are prohibited from making any such representations outside of the confines of the disclosure document. This prohibition encompasses any financial performance representations made in any advertisement or on a website directed at prospective franchisees. The making of any such contradictory representations is itself an independent violation of the amended Rule.

Financial Performance Representations: Historical or Projected?

The requirements of Item 19 vary depending upon whether a franchisor makes historical representations (how much existing franchisees have, in fact, earned in the past) or projections (how much an individual prospective franchisee is likely to earn in the future). In fact, Item 19 requires franchisors to state expressly whether any financial performance representation:

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- • pertains to historic performance of all or a subset of existing franchised outlets; or
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- is a forecast of future potential performance.

Historic Performance

A franchisor making an historic financial performance representation must state the material facts underlying the representation. Item 19 of the amended Rule specifies 6 separate elements comprising the material bases for such a representation, each of which must be expressly addressed:

1. **The Group Measured –**

Did All Outlets in the System, or Only Some of Them, Achieve the Stated Level of Performance?

A franchisor that makes an historic financial performance representation, in Item 19 must state whether the representation relates to the performance of all its existing outlets or only a subset of them sharing some characteristic (*e.g.*, all in the same geographic region or locale, all occupying free-standing premises as opposed to premises in a shopping center, or all in operation for at least 3 years). Of course, nothing prevents a franchisor from basing a financial performance claim on system-wide data, such as a survey of all franchised outlets to gather data on average sales. A franchisor may base a financial performance claim on data from fewer outlets than are in the entire system if these outlets share one or more characteristics in common. The amended Rule permits this, provided the franchisor discloses the characteristics of the outlets from which data are gathered to form the basis of the financial performance representation, and the total number of franchises in the franchise system.

Are the Outlets in the Measured Group Franchised Outlets? Company-owned? Outlets of an Affiliated System with Similar Operations?

The group from which data is gathered need not be comprised of franchised outlets. It may be a group consisting of company-owned outlets, or, in certain limited circumstances, a group of reasonably similar outlets of an affiliate with operations reasonably similar to those of the franchisor making the offering in question – *with two provisos*. The first proviso is that any financial performance representation a franchisor makes must be reasonable and supported by the data collected from the group. That means the franchisor must have written substantiation of the representation in the franchisor's possession at the time the representation is made. The second proviso is that the franchisor's disclosure must make clear whether the claim is based on the experience of company-owned outlets, of outlets of an affiliate with reasonably similar operations, or of franchised outlets in the same system as those being offered for sale.

2. **Time Period Measured –**

When Was the Stated Level of Performance Achieved?

Franchisors have the flexibility to use any reasonable time period. For example, a franchisor may wish to disclose sales or profit figures for franchisees over the last 2 fiscal years. Be mindful, however, that using a time period that is not fairly recent may generate performance results that no longer are relevant to current market conditions. Using data gathered too long ago – even if true when collected – may not provide a reasonable basis for a financial performance representation if it is no longer relevant to current conditions.

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, if the franchisor lacks adequate operating experience of its own, it may base a financial performance claim upon the results of operations of a substantially similar business of an affiliate. As in any case when a financial performance representation is based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of these outlets that may differ materially from the outlets being offered for sale in light of all the market changes that may have transpired since then. Likewise, representations based on the reasonably similar operations of an affiliate with reasonably similar operations may prove to be inaccurate or misleading, in a relatively short period of time, based on the actual operating experience of the franchisor's franchisees.

3. Number of Outlets Measured

How Many Outlets Are in the Group That Achieved the Stated Level of Performance, and How Many Are in the Entire System?

A franchisor must disclose the number of franchisees that were in the group or subgroup measured as compared to the number in the entire system, during the relevant time period.

4 . Number of Outlets Reporting

How Many Outlets in the Relevant Group Supplied the Performance Data Underlying the Representation?

Franchisors must also disclose the number of franchisees in the group about which the financial performance claim is made and from which the financial performance data were gathered. Data could be gathered from all members of a group sharing the specified characteristics, or from fewer than all members of that group. The franchisor's Item 19 disclosures would need to clearly disclose the number of franchisees who received questionnaires and how they were selected. The disclosure also could indicate how many responded to the questionnaire.

5. Number and Percentage of Outlets that Achieved the Stated Level of Performance

What Proportion of the Group Measured Achieved the Results Claimed?

With respect to the outlets that provided data used to arrive at the representation, franchisors must disclose both the number and percentage that actually attained or surpassed the stated results.

6. Distinguishing Characteristics

What Are the Common Attributes of the Outlets That Achieved the Stated Level of Performance?

The implicit assumption underlying any historic performance representation is that a prospective franchisee may achieve at least the same level of performance - although, of course, there is no guarantee that this will happen. Factors tending to call that implicit assumption into question must be disclosed. Thus, Item 19 calls for disclosure of any characteristic of the group or subgroup on

which a financial performance claim is based that might set that group apart from outlets currently being offered for sale.

Projected Performance

As is the case with historical financial performance representations, financial performance projections must have a reasonable basis, and must disclose the material bases and assumptions upon which the projection is based. The amended Rule does not enumerate specific factors that must be addressed in describing the bases for a projected financial performance representation. Nevertheless, if a franchisor makes a performance projection, its Item 19 disclosures must include sufficient facts to enable a prospective franchisee to make an independent judgment as to the validity of the projection. The Item 19 disclosures should include a description of the material information on which the franchisor relied in making the representation. This may include market studies, statistical analyses, franchisee profit-and-loss statements, as well as other types of information that prudent persons customarily rely on in making business decisions.

Assumptions underlying a financial performance representation must be disclosed because they go to the heart of the issue – the probability that a prospective franchisee will achieve performance similar to that projected. Thus, the assumptions underlying a forecast include significant factors upon which a franchisee’s future results may depend. These factors include, for example, economic or market conditions that are basic to a franchisee’s operation, and encompass matters affecting, among other things, a franchisee’s sales, the cost of goods or services sold, and operating expenses.

In this regard, if a projection is based upon the results of franchisees’ prior performance, the assumptions disclosed must explicitly encompass any characteristics of the outlets upon which the claim is based that differ materially from the outlets currently being offered for sale. Examples of characteristics that typically make a material difference from one outlet to another include: geographic location; type of business premises (*e.g.*, free-standing units as opposed to units in a shopping center); the extent of competition in the market area; the services or goods sold; assistance or services supplied by the franchisor; and whether the outlets are franchised or company-owned or operated. More specific guidance in preparing assumptions for performance projections can be gained from the American Institute of Certified Public Accountants (“AICPA”).

Admonition

The amended Rule’s Item 19 requires a clear and conspicuous admonition that a new franchisee’s individual financial results may differ from the results stated in the Item 19 disclosure. While no specific language is required, franchisors can look to the admonitions set forth in the original Rule as a model. These include:

For historical representations –

Some outlets have [sold] [earned] this amount. There is no assurance you’ll do as well. If you rely upon our figures, you must accept the risk of not doing as well.
--

For projections –

These figures are only estimates of what we think you may earn. There is no assurance you’ll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

Availability of Substantiation

If a franchisor elects to make a financial performance representation in Item 19, then it must also include a statement that written substantiation for the representation will be made available to the prospective franchisee upon reasonable request. In this context, the term “reasonable” pertains to time and location. A request is reasonable when the prospective franchisee gives the franchisor sufficient time to produce the substantiation at a convenient location, possibly at company headquarters or where the substantiation is stored if it contains confidential information or is voluminous. For example, franchisors are not expected to bring substantiation with them to a trade show. Accordingly, a request by a trade show attendee for substantiation that afternoon at the trade show would probably be deemed unreasonable.

Financial Performance Representations on a Specific Outlet Offered for Sale

The amended Rule’s Item 19 makes clear that a franchisor not wishing to make financial performance representations may nonetheless offer to show a prospective franchisee the actual operating results of a specific outlet being offered for sale. Such information, however, may only be furnished to potential purchasers of that outlet and no others.

Supplemental Representations

If a franchisor has furnished an Item 19 disclosure, it may furnish a prospective franchisee with a supplemental financial performance representation pertaining to a particular location or pertaining to a particular variation (*e.g.*, a kiosk, as opposed to a standard free-standing restaurant). Any such supplemental representation must be in writing, explain the departure from the financial performance representation set forth in the Item 19 disclosures, and be prepared according to the standards for financial performance claims noted above.

ITEM 20: OUTLETS AND FRANCHISEE INFORMATION

Item 20 of the amended Rule requires the disclosure of statistical information on the number of franchised outlets and company-owned outlets for the preceding 3-year period.

Statistical Information

Item 20 of the amended Rule requires 5 tables. The first table provides a system-wide summary of outlets, detailing the net changes in the number of outlets – both franchised and company-owned – over the last 3 fiscal years. The second tracks transfers of outlets, state by state, over the last 3 fiscal years. The third shows, state by state, changes in the status of franchised outlets over the last 3 fiscal years. Similarly, the fourth table displays, state by state, changes in the status of company-owned outlets over the last three 3 years. Finally, the fifth table projects new outlet openings in each state. It also shows the number of franchise agreements that have been signed but have not yet resulted in the opening of an outlet.

Outlets Signed but Not Opened

The amended Rule requires franchisors to report, for each state, the total number of franchise agreements that were signed, but where the outlet had not opened as of the end of the last fiscal year.

Projected Franchised and Company-Owned Outlets

In addition, Item 20 requires franchisors to report, state by state, the projected number of new franchised and company-owned outlets for the next fiscal year. The amended Rule does not provide specific instructions on how to make these projections. However, such projections must have a reasonable basis. A franchisor may consider historical market trends as well as its own track record.

Contact Information for Current Franchisees

Item 20 of the amended Rule requires disclosure of contact information for current franchisees. Franchisors may provide contact information for all current franchisees, or for all franchisees in the state where they are offering to sell franchises, if there are 100 or more franchises in the state. If not, contact information must be provided for franchisees in contiguous states, and then the next closest states, until contact information for at least 100 franchised outlets can be listed. If a franchisor has fewer than 100 current franchisees, contact information must be provided for all of them. To protect franchisee privacy, only the name of the franchisee and the address, and telephone number of his or her outlet must be disclosed. In the case of a franchise that may be operated from the franchisee's home, such as an Internet franchise, franchisors may substitute a post office box or current e-mail address for the home address for the same reasons. In that situation, franchisors should list only the telephone number of the franchisee's business, if there is a separate line for the business. If not, a listing of a valid email address will suffice.

Contact Information for Former Franchisees

Item 20 of the amended Rule requires the disclosure of contact information for every franchisees who:

- has had an outlet terminated, canceled, not renewed, or otherwise voluntarily or involuntarily ceased to do business under the franchise agreement during the most recently completed fiscal year; or
- has not communicated with the franchisor within 10 weeks of the disclosure document issuance date.

In order to protect the privacy of former franchisees, the amended Rule calls for the disclosure of only limited contact information. Specifically, franchisors should disclose only the name, city and state, and current business telephone number of a former franchisee. Only if the current business telephone number is unknown should the last known home telephone number of former franchisees be disclosed. Before disclosing the former franchisee's home telephone number, however, franchisors should first attempt to disclose any current business telephone number for the former franchisee. This is true even if the franchisee no longer conducts a business of the type operated as a franchisee. For example, a former restaurant franchisee may have become a real estate agent. In such a case, the franchisor should attempt to include the real estate office telephone number. If no current business telephone number exists – such as may be the case when a franchisee retires – then the franchisor may include the last known home telephone number for the franchisee.

If a former franchisee requests that alternative contact information be disclosed – such as an e-mail address, post office address, or personal home address – then it is not a violation of the

Franchise Rule for a franchisor to honor the such a request by substituting the contact information provided for the former franchisee's current business telephone number or last known home telephone number. Finally, to ensure that prospective franchisees are aware that contact information will be disclosed once they leave the system, franchisors must include the following statement, verbatim, in the Item 20 disclosure of former franchisees: "If you buy this franchise, your contract information may be disclosed to other buyers when you leave the franchise system."

Previous Owner Information

The amended Rule requires franchisors to provide certain information if they are selling a specific outlet under their control that was previously owned by a franchisee. Franchisors are not required to make this disclosure, however, if they do not currently own and offer such an outlet for sale. A franchisor also is not obligated to make this disclosure if it assists a current franchisee in selling his or her outlet. Nor does a franchisor have an obligation to make this disclosure if it is selling a unit that has always been a company-owned outlet.

If the franchisor is selling a previously-owned franchised outlet now under its control, it must disclose the following information for the last 5 fiscal years:

- The name, city and state, current business telephone number, or if unknown, last known home telephone number of each previous owner of the outlet;
- The time period when each previous owner controlled the outlet;
- The reason for each previous ownership change; and
- The time period(s) when the franchisor retained control of the outlet.

If multiple units with previous franchisee-ownership are being sold, the franchisor must provide the required information separately for each one.

The amended Rule gives franchisors the flexibility to include this required information either in the text of Item 20 or in an addendum to the disclosure document. It is possible that a franchisor may not intend to offer a specific unit at the time disclosure is made to a particular prospective franchisee, or that a specific unit may become available only after a disclosure is made. In that case, franchisors need not redistribute revised disclosure documents. Rather, franchisors can comply with this requirement by providing the information in a supplement. Because it is deemed part of the FDD, the supplement must be given to the prospective franchisee at least 14 days before the signing of the franchise agreement or payment of any fees.

Confidentiality Agreements

In some instances, the amended Rule requires franchisors to disclose if franchisees have signed a confidentiality agreement with the franchisor during the last 3 fiscal years. If so, franchisors must include the following prescribed statement, verbatim, in Item 20:

In some instances, current and former franchisees sign provisions restricting their ability to speak only about their experience with [name of franchise system]. You may wish to speak with current and former franchisees, but be aware that not all such franchisees will be able to communicate with you.

What Constitutes a “Confidentiality Agreement”?

The term “confidentiality agreement” encompasses “any contract, order, or settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor’s system with any prospective franchisee.” A confidentiality agreement typically arises as part of the resolution of a dispute between the franchisor and franchisee. The requirement to disclose confidentiality agreements is narrow. It specifically is limited to agreements that restrict a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor’s system. The definition of “confidentiality agreement” expressly excludes clauses designed to protect franchisors’ trademarks or other proprietary information. Accordingly, a franchisor that requires prospective franchisees to sign a confidentiality agreement in order to receive or to review a copy of the franchisor’s operating manual would not trigger this disclosure requirement.

Optional Additional Disclosures

In addition to requiring the prescribed FDD, the amended Rule permits franchisors, if they wish, to provide additional information that will help a prospective franchisee understand the franchisor’s use of confidentiality clauses. Specifically, franchisors may note the number and percentage of current and former franchisees that, during each of the last 3 fiscal years, signed agreements containing confidentiality clauses, as well as the circumstances under which such clauses were signed.

Franchisee Associations

The amended Rule requires franchisors to disclose contact information for trademark-specific franchisee associations. This disclosure requirement pertains solely to associations of franchisees of the franchise brand being offered for sale. It does not pertain to associations of franchisees whose membership is opened to franchisees of many franchise systems. Nor does it pertain to associations of franchisees under a brand owned by the franchisor that is not the subject of the franchise offering. To be considered a “trademark-specific association,” the association need not include a reference to the trademark in its name. As long as members of the association are franchisees conducting business under the brand being offered in the FDD, the association is deemed a “trademark-specific” franchisee association.

The amended Rule’s disclosure requirements pertaining to franchisee associations differ depending on whether the franchisee association is created, sponsored, or endorsed by the franchisor, or whether the trademark-specific franchisee association is independent of the franchisor.

Associations Created, Sponsored, or Endorsed by the Franchisor

If the franchisor creates, sponsors, or endorses a trademark-specific franchisee association, it must disclose in Item 20 the name, address, telephone number, e-mail address, and web address of the association. It also must disclose the specific relationship between the franchisor and the association (*i.e.*, that it was created, sponsored, or endorsed by the franchisor). Franchisor sponsorship or endorsement is enough to trigger this disclosure requirement; the franchisor need not have established the association. A franchisor will be deemed to “sponsor” an association if it contributes to the association financially, or provides tangible benefits such as office space, equipment, or personnel. A franchisor will be deemed to “endorse” an association if takes affirmative steps to promote awareness of the association, its membership, or growth. For example,

the franchisor may include a link to the association on its website or routinely report on the association's activities in its newsletter. Merely recognizing the existence of the association – such as agreeing to meet with one or more of its members or referencing the existence of the association in an e-mail – alone will not be deemed either sponsorship or an endorsement.

Independent Franchisee Associations

The amended Rule requires franchisors to disclose contact information for independent trademark-specific franchisee associations under limited circumstances. An “independent” franchisee association is one that was not created by the franchisor, and is neither sponsored nor endorsed by the franchisor. Typically, such an association is organized and funded by franchisees for the benefit of the franchisees, often without any knowledge of the franchisor.

Franchisors have no obligation to disclose contact information for independent franchisee associations unless each of the following criteria is satisfied:

- the association is organized under state law;
- the association expressly asks for inclusion in the disclosure document; and
- the association timely renews its request for inclusion on an annual basis.

“Organized under State Law

To be considered for inclusion in the FDD, the independent association must be organized under state law. It need not be incorporated. For example, it can be organized as a trust. The “organized under state law” requirement is interpreted very broadly. However, informal get-togethers by franchisees will not satisfy the “organization under state law” criteria. This will be true even if the informal group of franchisees publishes a newsletter or maintains a website.

Request for Inclusion

A franchisor has no obligation to disclose contact information for an organized independent association unless the association has asked to be included in the franchisor's disclosure document for the next fiscal year. To be included in the FDD, the association must request inclusion no later than 60 days after the close of the franchisor's fiscal year.

Annual Renewal

Once a valid request is made for inclusion in a FDD an independent association, the franchisor must include the required contact information for the entire fiscal year. The franchisor need not verify the continued existence of the association during the course of the year. However, if the franchisor has knowledge that the association has ceased to exist, it can always add a footnote to the disclosure document alerting prospective franchisees of the change in status of the independent group. Similarly, the franchisor has no obligation to discover the existence of any new independent associations during the course of the fiscal year. This disclosure is required on an annual basis only and need not be updated quarterly.

ITEM 21: FINANCIAL STATEMENTS

The amended Rule requires franchisors to include in Item 21 copies of their financial statements audited in accordance with generally accepted accounting principals (“GAAP”) for the most recent 3 fiscal years to show the financial condition of the franchisor. The financial statements of franchisors that own a direct or beneficial controlling financial interest in one or more subsidiaries must also reflect the financial condition of the subsidiaries. Financial disclosures must be in tabular format that compares at least 2 fiscal years. This provides prospective franchisees with information with which to assess financial trends in a franchise system.

GAAP Requirement

The amended Rule requires franchisors to prepare financial statements according to “United States generally accepted accounting principles, as revised by any future government mandated accounting principles, or as permitted by the Securities and Exchange Commission.” The amended Rule updates the UFOC Guidelines by recognizing that what currently complies with “GAAP” may change as a result of federal government oversight of the accounting profession. Accordingly, it provides that franchisors must use GAAP, as revised by any future government mandated accounting principles.

At the same time, the amended Rule provides flexibility by permitting franchisors to comply with the Rule’s audited financial statement requirement by looking to principles articulated by the Securities Exchange Commission (“SEC”). This is most important for foreign franchisors wishing to sell outlets to be located in the United States. The amended Rule permits foreign franchisors to use United States GAAP or to reconcile their financial statements to United States GAAP, consistent with SEC law.

Parent Financial Information

Item 21 of the amended Rule provides that a franchisor must also disclose the financial statements of any parent corporation in 2 circumstances: (1) when the parent commits to perform post-sale obligations for the franchisor; or (2) when the parent guarantees obligations of the franchisor. In these circumstances, prospective franchisees may reasonably consider the parent’s financial status in their investment decision-making. Accordingly, the parent’s financial status is material.

Affiliate Financial Information

The amended Rule also permits a franchisor to substitute the financial statements of an affiliate for its own financial statements if the affiliate’s statements meet the Rule’s requirements for audited statements and the affiliate absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor to the franchisee under the franchise agreement. A copy of the guarantee, which need not extend to third parties, must be included in the attachments to the FDD in Item 22.

Subfranchisor Financial Information

The amended Rule requires the disclosure of financial information of any subfranchisor. The term “subfranchisor” is limited to circumstances where the subfranchisor steps into the shoes of the franchisor by engaging in pre-sale activities and performing post-sale obligations. It does not

include those individuals who may be called “subfranchisors,” but who act like brokers or salespersons, having no post-sale commitments to franchisees. Where a person engages in pre-sale activities and commits to perform under the franchise agreement, his or her financial information becomes material in order to provide prospective franchisees with the opportunity to assess that person’s financial condition.

Phase-In of Audited Financial Statements

Item 21 of the amended Rule permits franchisors to phase-in the use of audited financial statements over the course of 3 years. The phase-in applies only to companies that are new to franchising and that do not yet have audited financial statements. If an existing company has prepared audited financial statements in the ordinary course of business before embarking on franchise sales it may not use the phase-in. Moreover, the phase-in is not available to spin-offs, affiliates, or subsidiaries of existing franchisors that have prepared audited financial statements in the past. In short, an existing franchise system cannot avoid the obligation to provide full audited financial statements by forming a spin-off company.

ITEM 22: CONTRACTS

Item 22 of the amended Rule requires franchisors to attach a copy of all proposed agreements relating to the franchise offering that the franchisor provides or for which the franchisor makes arrangements. These include not only the franchise agreement, but leases, options, financing agreements, and purchase agreements. These attachments are part of the FDD. The attached agreements should be the same as those listed in the Table of Contents and in the Receipt.

ITEM 23: RECEIPTS

The amended Rule requires franchisors to obtain a signed receipt for the FDD furnished to each prospective franchisee. When preparing the receipt, franchisors must follow the form of the receipt set forth in Item 23. In addition, Item 23 adopts the current industry practices of including two copies of the receipt at the end of the disclosure document: one that the franchisee retains as part of the disclosure document, and the other that the franchisee must return to the franchisor. The amended Rule’s general recordkeeping requirements, discussed below, also require franchisors to retain a copy of each signed receipt for at least three years to demonstrate compliance.

To facilitate electronic disclosures, the definition of “signature” is very broad, including any means by which a franchisee can authenticate his or her identity. It includes not only a handwritten signature, but also the use of security codes, unique passwords, electronic signatures, or similar means of authentication. Accordingly, the amended Rule specifically permits a prospective franchisee to “sign” a disclosure document receipt electronically. For example, a prospective franchisee might “sign” the receipt page of a disclosure document by entering a unique password provided by the franchisor. Today, many FDD are delivered by e-mail in a pdf with the franchisor asking the franchisee to print out the Receipt, sign it and return it to the franchisor.

Name of Seller

Item 23 of the amended Rule requires franchisors to name and provide contact information (principal business address and telephone number) for each specific seller offering the franchise.

This includes any company salespersons, subfranchisors, or independent franchise brokers who may deal with a prospective franchisee. Because this information may vary with each franchise offered for sale, a franchisor can comply with this provision either by leaving a blank space in the standard disclosure document that can be filled in by the seller or by including the name(s) and contact information in an attachment to Item 22, which is then referenced in the Item 23 receipt.

Issuance Date

The receipt must include the issuance date of the disclosure document. An “issuance” date is very flexible, meaning any date upon which the franchisor finalizes the current version of the disclosure document for use. States that require registration, however, may use the term “effective date,” to mean the date upon which the state formally approves registration of the disclosure document. Where a franchisor seeks registration in registration states, the franchisor may use, in lieu of an issuance date, an “effective” date to comply with state law. Franchisors obtaining an effective date from a registration state may also use the term “effective date” in non-registration states.

V. INTERNATIONAL FRANCHISE EXPANSION MODLES

INTRODUCTION

While the typical franchise arrangement is a franchise agreement between a franchisor and a franchisee for a single outlet (direct franchising), there are also more complex arrangements involving multi-outlet franchise arrangements and multi-level franchise arrangements. A multi-outlet franchise arrangement is usually described as an area development arrangement. There are two typical multi-level franchise arrangements, subfranchising and area representation. In each case there is an intermediary between the franchisor and the franchisee. This intermediary is responsible for the sale and servicing of the franchisees on behalf of the franchisor.

INTERNATIONAL FRANCHISE EXPANSION MODELS

The typical international franchise expansion models are:

Direct Franchising - Single Unit or Area (Multi-Unit) Development;

Joint Venture;

Area Representation (Development Agents); and

Subfranchising (Master) Franchising;

DIRECT FRANCHISING - SINGLE UNIT OR AREA (MULTI-UNIT) DEVELOPMENT

“Direct Franchising” involves a foreign franchisor directly entering the United States through its foreign entity or a wholly owned U.S. state corporation subsidiary that acts as franchisor under franchise agreements with franchisees operating in the United States of its Territories.

If a person wants to own and operate more than one outlet, the person becomes an area developer. An area developer is really a multi-outlet franchisee. Usually, the franchisee and the franchisor will sign an area development agreement at the same time the first single-outlet franchise agreement is signed. The area development agreement gives the franchisee the right to open 2 or

more units over a period of time (the "development schedule") within a specified area (the "development area"). If a franchisor offers area development rights, the offer will usually be included in the franchisor's FDD for a single outlet franchise with various ITEMS of the FDD discussing the area development agreement and a copy of the area development agreement attached as an exhibit.

JOINT VENTURE

"Joint Venture" involves a foreign franchisor entering the United States by entering into a U.S. state joint venture with a U.S. company. The joint venture will be responsible for directly franchising (single outlet or area development) and/or opening company-owned outlets in the United States of its Territories.

AREA REPRESENTATION (DEVELOPMENT AGENTS)

An area representative is best described as a "super" franchise broker and servicing agent for the franchisor. An area representative will be disclosed in ITEM 2 of the franchisor's Franchise Disclosure Document (FDD), and his, her or its 5-year biography and 10-years litigation and bankruptcy history must be included in ITEMS 2, 3 and 4 if the area representative provides ongoing services to the franchisees.

An area representative differs from a subfranchisor in that the area representative uses the franchisor's FDD and the franchise agreement is signed directly between the franchisor and the franchisee. The area representative is not a party to the franchise agreement. Under the area representative agreement between the franchisor and the area representative, the franchisor delegates to the area representative certain of the servicing and support obligations of the franchisor to the franchisee. All initial franchise fees, royalties and other payments are usually paid by the franchisee directly to the franchisor. The franchisor then remits a portion of these fees to the area representative as negotiated in the area representative agreement.

The sale of area representative rights may or may not be considered to be the sale of a "franchise" under federal and state franchise laws. There appears to be no specific law, regulation or case on point. The majority of franchise lawyers seem to be of the opinion that, if the area representative pays a fee of \$500 or more for the area representative rights, then it is a franchise. If so, a separate FDD must be given by the franchisor to the prospective area representative disclosing the area representative relationship.

In our international situation, the foreign franchisor would form a U.S. subsidiary and appoint area representative as its agents to sell and services franchisees on behalf of the U.S subsidiary

SUBFRANCHISING (MASTER) FRANCHISING

A subfranchisor is a person who is granted the right to sell the foreign franchisor's franchises and, perhaps, also own and operate these franchises as a franchisee. A subfranchisor is sometimes called a "master franchisee," particularly in international deals. A subfranchisor steps into the shoes of the franchisor and acts as the franchisor in a given area (for example, a country). A subfranchisor sells the franchises and directly enters into a franchise agreement with a franchisee. The foreign franchisor is not a party to the franchise agreement.

A subfranchisor is subject to the FTC Franchise Rule and state franchise registration and disclosure laws to the same extent as the foreign franchisor. Therefore, a subfranchisor is also obligated to have its own FDD, which includes certain information about the foreign franchisor, its own audited financial statements, and state registration if offering franchises in a registration state, etc.

Usually, an offer of subfranchise rights is made separate and apart from the offer of a single outlet franchise or area development rights. There is a separate FDD prepared by the franchisor and given only to prospective subfranchisors describing the subfranchise relationship and including a copy of the subfranchise agreement.

KEY ISSUES IN STRUCTURING AN INTERNATIONAL MASTER FRANCHISE AGREEMENT

In negotiating and drafting an international master franchise agreement, the following key issues should be addressed:

1. Description of the right to be granted by the U.S. franchisor to the master franchisee, including the proprietary marks, know-how, confidential information, manuals, right to franchise, etc.
2. The master franchise territory;
3. Exclusivity;
4. Initial term and renewal term;
5. Duties of the U.S. franchisor;
6. Master franchise fee, sharing of initial franchise fee and royalties and other fees such as renewal fee and transfer fee (including type and method of payment, risk of currency fluctuations, exchange controls and inflationary safeguards);
7. Withholding of taxes and gross up provisions;
8. Duties of the master franchisee;
9. Schedule of development;
10. Proprietary marks;
11. Confidential manuals and confidential information;
12. Accounting and records;
13. Transfer of interest (assets or stock);
14. Default and termination;
15. Obligations upon termination;
16. Independent contractor and indemnification;

17. Representations and warranties; and
18. Choice of law and venue.

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