

COMMENTARY ON
2008 FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES

INTRODUCTION

On June 6, 2008, the North America Securities Administrators Association, Inc. (“NASAA”) adopted the 2008 Franchise Registration and Disclosure Guidelines as a model for states with a specific franchise registration and disclosure law. The 2008 Franchise Guidelines amend and restate NASAA’s 1993 Uniform Franchise Offering Circular (“UFOC”) Guidelines, which became the most commonly used format for franchise disclosure throughout the United States until 2007, when the Federal Trade Commission adopted the Amended Franchise Rule, 16 C.F.R. Part 436.

Between 1994 and 1999, the NASAA Franchise and Business Opportunities Project Group (the “Project Group”), in consultation with its Industry Advisory Committee, staff from the Federal Trade Commission, and others with an interest in franchising, published several commentaries to the UFOC Guidelines. The UFOC commentaries expressed the Project Group’s interpretation of specific issues that had arisen under the UFOC Guidelines, in an effort to achieve a more uniform approach to franchise disclosure under state franchise registration and disclosure laws.

The 2008 Franchise Guidelines adopted the new disclosure requirements under the FTC’s Amended Franchise Rule as of July 1, 2008, with a new state cover page, new filing instructions, and new application forms. Because the disclosure requirements under the FTC’s Amended Franchise Rule are based, in large part, on the 1993 UFOC Guidelines, the new FTC requirements are somewhat familiar to franchisor representatives and state franchise examiners. Since July 1, 2007, states that register franchise offerings have received Franchise Disclosure Documents prepared under the FTC’s Amended Franchise Rule. As of the date of this Commentary, state franchise examiners have reviewed thousands of Franchise Disclosure Documents prepared under the new disclosure requirements, and those examiners and franchisors have raised questions of interpretation. Although the FTC staff has provided guidance by posting a number of “Frequently Asked Questions” (“FAQs”) about the Amended FTC Franchise Rule and has published a Compliance Guide, some practical issues remain unresolved.

The following Commentary is intended to provide practical guidance about the disclosure requirements and instructions adopted under NASAA’s 2008 Franchise Guidelines. In most cases, the items address questions raised by state examiners or franchisor representatives and are based on Franchise Disclosure Documents filed with state franchise authorities. The Commentary also incorporates several earlier commentary items the Franchise Project Group adopted under the UFOC Guidelines, to the extent those commentary items apply under the new requirements and are not otherwise reflected in the Amended FTC Franchise Rule, the FTC’s Franchise Rule Compliance Guide, or FTC staff’s responses to Frequently Asked Questions. The Franchise Project Group consulted with the FTC staff before finalizing these Commentary items.

The NASAA Franchise and Business
Opportunities Project Group

0.1 *FTC Cover Page – Total Investment*

QUESTION

On the FTC Cover Page, regarding the disclosure of the total investment necessary to begin operation, may the franchisor add additional clarifying information?

ANSWER

No. Franchisors may not add information not required by the rule or by a state examiner. However, if the Franchise Disclosure Document offers multiple concepts, such as an area development agreement and single-unit franchises in a single disclosure document, the franchisor must make a separate total investment disclosure on the FTC Cover Page for each concept offered.

0.2 *FTC Cover Page – Adjusted Numbers*

QUESTION

On the FTC Cover Page, regarding the disclosure of the total investment necessary to begin operation, may the franchisor adjust the actual totals from Items 5 and 7 to reflect the fact that some franchisees may not incur some specified fees or expenses?

ANSWER

No. Franchisors must use the actual total amounts from Items 5 and 7 without alteration, adjustment or explanation.

0.3 *State Cover Page — State Risk Factors*

QUESTION

If a state requires the inclusion of additional risk factors, must they be added to all Franchise Disclosure Documents used in the U.S.?

ANSWER

A franchisor must make its own determination as to whether one state's requirement is material in other states. A risk factor imposed by one state may well be material to prospective franchisees in other states and may be included in the franchisor's state cover page in other states. State franchise laws have no extraterritorial effect, however, and the requirements of one state should not automatically be imposed on a franchisor's offers in another state.

0.4 *State Specific Addenda*

QUESTION

Where should franchisors locate state specific addenda and state specific amendments to the franchise agreement or other documents?

ANSWER

Unless a state franchise law requires otherwise, state specific addenda to the Franchise Disclosure Document should be included with the other Exhibits to the Franchise Disclosure Document, but before the Receipt Pages. Franchisors should place state specific amendments to the franchise agreement or other documents either in the state addenda exhibit or in a separate exhibit. In either case, the location of any state specific addenda and state specific amendments to the franchise agreement or other documents should be identified in the Table of Contents to the Franchise Disclosure Document.

1.1 *Item 1 – Principal Business Address*

QUESTION

The definition of “principal business address” means the street address of a person’s home office “in the United States.” What if a foreign franchisor does not have an office in the U.S.?

ANSWER

A non-U.S. franchisor is not required to establish an office in the United States if it does not have one. In that event, the Franchise Disclosure Document should state that the franchisor does not have a principal business address in the U.S. and provide information on its foreign principal business address. If the franchisor has an office in the United States, however, it must disclose the address of that office in Item 1.

1.2 *Item 1 – Disclosure of Numerous Parent Companies*

QUESTION

Can a franchisor present information on numerous parent companies in a Chart for Item 1 purposes?

ANSWER

Yes, as long as the information is presented in a clear and understandable format that is not confusing.

1.3 *Item 1 — Predecessor — Change of Ownership*

QUESTION

If control of a franchisor changes, is a former controlling owner a predecessor?

ANSWER

No. A predecessor is defined as a person from whom the franchisor acquired directly or indirectly the major portion of the franchisor's assets. The determination of what constitutes the major portion of a franchisor's assets is made as of the date of the franchisor's acquisition of those assets. The definition of a predecessor does not mean mere equity owners of the franchisor. Implicit in the definition of "predecessor" is the requirement that the predecessor contributed operating assets to the franchisor and itself operated or franchised a similar business. Therefore, a change in control of a franchisor does not affect the determination of whether a former controlling owner is a "predecessor."

1.4 *Item 1 — Foreign Affiliates*

QUESTION

Must foreign affiliates, including addresses, be listed in Item 1?

ANSWER

Yes. All affiliates, including foreign affiliates, that offer franchises in any line of business or provide products or services to the franchisees of the franchisor must be disclosed in Item 1. If the list is extensive, addresses may be listed in an exhibit to the Franchise Disclosure Document.

2.1 *Item 2 - Disclosure of Individuals*

QUESTION

Should all members of a limited liability company be listed?

ANSWER

Only individuals should be listed in Item 2. Members (individuals) should be listed in Item 2 only if they fall into one of the designated categories.

2.2 *Item 2 – Management Responsibilities*

QUESTION

Can independent contractors or employees of an unaffiliated third party have management responsibilities relating to the sale or operation of franchises for purposes of Item 2 disclosures?

ANSWER

Yes. An independent contractor or any other person who has management responsibilities on behalf of the franchisor relating to the sale or operation of the franchises offered, regardless of what that person's title may be, must be shown in Item 2 and must provide the necessary disclosure for Items 3 and 4.

3.1 *Item 3 — Felonies*

QUESTION

Are felonies of all kinds required to be disclosed in Item 3(1)(iii)(A)?

ANSWER

Yes. Item 3(1)(iii)(A) requires disclosure of all felony convictions and pleas of nolo contendere to any felony charge. This disclosure is not limited to felonies involving the specific matters listed in Item 3 (1)(i)(A) (for example, actions alleging a violation of a law related to antitrust, securities, franchise of fraud).

3.2 *Item 3 — Predecessor Litigation*

QUESTION

If a franchisor's predecessor is no longer affiliated with the franchisor, what is the franchisor's obligation to obtain updates of litigation against the predecessor that the predecessor disclosed in its Franchise Disclosure Document before the franchisor obtained control of the franchised business?

ANSWER

A franchisor must make reasonable efforts to obtain updates of a predecessor's litigation that is required to be disclosed but, if it is unable to obtain information from the predecessor, or from court dockets or other publicly available sources, it may note this fact in Item 3.

3.3 *Item 3 – Trademark, Patent or Copyright Litigation*

QUESTION

Must trademark litigation challenging the validity of a trademark disclosed in Item 13, or patent or copyright litigation challenging the validity of a patent or copyright disclosed in Item 14, also be disclosed in Item 3?

ANSWER

Item 13 requires disclosure of any pending material federal or state court litigation, and any currently effective material court determinations regarding the franchisor's use or ownership rights in a trademark. Item 14 requires disclosure of any material proceeding pending in the U.S. Patent or Trademark Office or in any court. Civil actions disclosed in Item 13 or 14 must be disclosed in Item 3 if they meet the disclosure requirements of Item 3.

3.4 *Item 3 – No Litigation to Report*

QUESTION

For purposes of Item 3, what disclosure should a franchisor make if it has no litigation to report?

ANSWER

If a franchisor has no litigation to report in Item 3, the franchisor should state "No litigation is required to be disclosed in this Item."

3.5 *Item 3 – Held Liable*

QUESTION

The UFOC Guidelines required disclosure if a person had been the subject of a material action involving violation of a franchise, antitrust or securities law, fraud, unfair or deceptive practices or comparable allegations during the past ten years. Item 3 now requires disclosure if a person was "held liable" in a civil action involving an alleged violation of a franchise, antitrust or securities law, or involving allegations of fraud, unfair or deceptive practices, or comparable allegations during that period of time. Is this a different standard?

ANSWER

No. The term "held liable" has a special meaning in this context. It means that the person must pay money or other consideration or must reduce an indebtedness by the amount of an award. It also includes situations in which the party is restricted from enforcing its rights or must take action adverse to its interest. If a person is not required to pay a material amount or its rights are not materially restricted, no disclosure is required.

4.1 *Item 4 – No Bankruptcy to Report*

QUESTION

For purposes of Item 4, if a franchisor has no bankruptcy information to report, what disclosure should the franchisor make?

ANSWER

If a franchisor has no bankruptcy information to report, the franchisor should state “No bankruptcy is required to be disclosed in this Item.”

8.1 *Item 8 — Scope*

QUESTION

A variety of terminology is used throughout Item 8 to refer to a wide range of sourcing restrictions. What is the scope of Item 8?

ANSWER

Item 8 requires disclosure of all restrictions on the freedom of the franchisee to obtain goods, real estate, services, etc. from sources of the franchisee’s choosing, and of all means by which a franchisor may derive revenue as a result of franchisee purchases or leases of goods and services. All revenues a franchisor (or its affiliates) derives from purchases and leases of products and services to franchisees must be disclosed.

8.2 *Item 8 - Rebates*

QUESTION

Item 8 refers to disclosing rebates paid by “designated suppliers.” Is disclosure required from a broader range of suppliers?

ANSWER

Yes. Item 8 requires disclosure of the franchisee’s obligations to purchase or lease goods or services either from the franchisor, its affiliates, its designees or suppliers approved by the franchisor, or under the franchisor’s specifications. Therefore, disclosure is required if rebates are paid by designated or approved suppliers or by suppliers who comply with the franchisor’s specifications.

10.1 *Item 10 – Financing Arrangements*

QUESTION

Item 10 does not specifically exclude financing arrangements where payments are due within 90 days on open account financing. Should such payments be disclosed?

ANSWER

No. Payments due from a franchisee to a franchisor within 90 days on an open account financing arrangement need not be disclosed under Item 10.

10.2 *Item 10 - Financing Contract Forms*

QUESTION

Item 10 requires attaching samples of financing contracts that the franchisee may sign. Excluding the principal franchise agreements, if there are variations in any collateral contracts, must all of the forms be attached to the Franchise Disclosure Document?

ANSWER

In some cases, attaching every variation of a collateral financing contract that a franchisee must sign as part of a franchise purchase may unduly clutter the Franchise Disclosure Document and discourage review of the Franchise Disclosure Document by prospective franchisees. If there are variations in a particular type of collateral contract (e.g., loan agreements that vary state by state) a sample document will suffice. If there are any material differences in the contracts, those differences should be disclosed in the text of Item 10 or in state specific addenda.

10.3 *Item 10 - No Financing*

QUESTION

For purposes of Item 10, what disclosure should the franchisor make if it does not offer a financing arrangement?

ANSWER

If a franchisor does not offer a financing arrangement, the franchisor should state “We do not offer direct or indirect financing. We do not guarantee your note, lease or obligation.”

17.1 Item 17 – Franchise Relationship Laws

QUESTION

Item 17 does not require that the franchisor include a list of franchise relationship laws following the mandated chart. May a franchisor include a list of such laws?

ANSWER

No. A listing of state franchise relationship laws (previously required by the UFOC Guidelines) is no longer permitted. A state may, however, require a summary of its franchise relationship law in an Addendum.

19.1 Item 19 - Exclusion of Costs

QUESTION

Item 19 no longer includes costs in the definition of a financial performance representation. Can cost information be provided outside of Item 19 in a form that sets forth those expenses as a percentage of revenues?

ANSWER

No. If a franchisor provides information about a prospective franchisee’s anticipated operating expenses as a percentage of a stated level of revenue, that information constitutes a financial performance representation, and a franchisor may provide that information only if it complies with the requirements of Item 19.

19.2 Item 19 – Pro Formas

QUESTION

Can the franchisor attach a blank “pro forma” to the franchise disclosure document and treat it as a financial performance representation?

ANSWER

No. A blank pro forma that identifies categories of revenue and costs but without corresponding figures is not a financial performance representation and should not be attached or otherwise included in a Franchise Disclosure Document. A blank pro forma, or a pro forma that contains cost information alone, may constitute franchise advertising under state franchise statutes, depending on how the franchisor uses that document.

19.3 *Item 19 – Disclaimers*

QUESTION

Under Item 19, when a franchisor makes a financial performance representation, what is an appropriate “clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation?”

ANSWER

While Item 19 does not require any specific language, franchisors should use one of the following admonitions in a separate paragraph:

For historical representations—

“Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.”

For projections—

“These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.”

In either case, franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented.

20.1 *Item 20 – Franchisees Who Never Open*

QUESTION

If a franchisee has signed a franchise agreement but has not opened an outlet, how should the franchisee be disclosed in Item 20?

ANSWER

Franchisees who have signed a franchise agreement and are still in the franchise system but have not yet opened an outlet should be shown only in Table 5. They should also be listed in the contact list of franchisees required by Item 20, but segregated or clearly identified as “not yet opened” as of the last fiscal year end. If such franchisees have no outlet addresses, the franchisor should provide the franchisee’s name, city and state, current business telephone number or e-mail address. Franchisees who have signed a franchise agreement but never open an outlet and are no longer in the system or have not communicated with the franchisor within 10 weeks of the disclosure document issuance date should not be shown in any chart, but should be included in the list of terminated franchisees with the contact information required by Item 20.

20.2 *Item 20 – Area Developers*

QUESTION

Must information on area developers be separately stated in Item 20?

ANSWER

No. “Area developers” are franchisees who receive the right to open multiple outlets. Item 20 does not permit separate charts or lists of outlets of area developers. However, disclosure regarding the area development arrangements must be included, as appropriate, in other Items of the Franchise Disclosure Document.

20.3 *Item 20 – Area Representatives*

QUESTION

Must information be included in Item 20 for third parties who may solicit prospective franchisees and perform services on behalf of the franchisor, but who do not have a contractual obligation with franchisees to do so (sometimes referred to as development agents or area representatives)?

ANSWER

Some state laws may treat these arrangements as subfranchises and in those states, disclosure may be required. Under Item 20, however, such arrangements do not constitute a subfranchise. Accordingly, while such programs should be described in the franchise disclosure document, separate charts and lists of these third parties are not required to be included in Item 20.

20.4 *Item 20 – Subfranchisor Disclosure*

QUESTION

What are the disclosure requirements in Item 20 for offerings by a subfranchisor (sometimes called a master franchise offering)?

ANSWER

The charts in Item 20 refer to “outlets” which are defined as including “outlets of a type substantially similar to that offered to the prospective franchisee.” Therefore, a subfranchisor’s franchise disclosure document must include two sets of Item 20 charts: one listing all the individual outlets, whether franchised or subfranchised, in the entire system, and another listing only the individual subfranchised outlets for that particular subfranchisor. The subfranchisor’s Item 20 charts should not include a listing of all subfranchisors in the system.

20.5 *Item 20 - Lists of Franchisees*

QUESTION

How must franchisees be listed in an exhibit?

ANSWER

Franchisees should be listed by state, with states in alphabetical order, then within each state by city, with cities in alphabetical order. This applies to the lists of current franchisees and former franchisees.

20.6 *Item 20 - Local Franchisee Associations*

QUESTION

If a franchisor has local advertising councils or cooperatives, are those organizations disclosable in the Franchise Disclosure Document as a franchisee association?

ANSWER

No. A local advertising council or cooperative should not be disclosed in Item 20 as a trademark-specific franchisee organization. Information about local advertising councils and cooperatives should be disclosed as required by Item 11.

20.7 *Item 20 - Disclosure of Franchisor as of a more current date*

QUESTION

Item 20 requires charts to be prepared as of the end of the last fiscal year, and the list of franchisees must include all current franchisees as of that date. The list of terminated franchisees should be as of the last fiscal year end. Can the franchisor provide a list of terminated franchisees that is current as of a more recent date than the last fiscal year end?

ANSWER

Yes. The list can be supplemented with a list of terminated franchisees that is more current than the last fiscal year end. In addition, the list of current franchisees can also be more current than the last fiscal year end. However, the more current lists should be segregated from the others.

20.8 *Item 20 – Start-up Franchisors*

QUESTION

Should a start-up franchisor include Charts 2 and 3 in Item 20?

ANSWER

Yes. Although start-up franchisors may not have numbers to insert in Charts 2 and 3, they should still include all charts in Item 20.

20.9 *Item 20 – States With No Franchises*

QUESTION

In charts 2, 3, 4 and 5 must a franchisor include rows listing all states even if the franchisor had franchisees in only one or a few states?

ANSWER

No. In charts 2, 3, 4 and 5, franchisors should only include rows listing the states in which the franchisor has or had franchisees subject to the applicable disclosure requirement. In all cases, franchisors must include the “total” row(s).

20.10 *Item 20 – Disclosure Of Confidentiality Clauses*

QUESTION

If a franchisor's franchisees have signed confidentiality clauses during the last three fiscal years, what must a franchisor disclose?

ANSWER

If a franchisor’s franchisees have signed confidentiality clauses of the type required to be disclosed under Item 20, the franchisor should make two separate disclosures. First, the franchisor should state that its franchisees have signed “confidentiality clauses” during the last three fiscal years. Second, the franchisor should include the mandated legend under Item 20(7) that, “In some instances, current and former franchisees sign provisions restricting their ability to speak openly 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.”

20.11 Item 20 – *Disclosure Of Confidentiality Clauses*

QUESTION

If a franchisor's franchisees have *not* signed confidentiality clauses during the last three fiscal years, what must a franchisor disclose?

ANSWER

If a franchisor's franchisees have not signed confidentiality clauses of the type required to be disclosed under Item 20, the franchisor should state that “During the last three fiscal years, no current or former franchisees have signed confidentiality clauses that restrict them from discussing with you their experiences as a franchisee in our franchise system.”

20.12 Item 20 — *International*

QUESTION

Must international outlets be listed?

ANSWER

No. A franchisor is permitted to include a list of international outlets, however, as long as they are substantially similar to the outlets being offered, but is not required to do so.

22.1 Item 22 - *Contract Forms*

QUESTION

Item 22 requires attaching samples of contracts that the franchisee may sign. Excluding the principal franchise agreements, if there are variations in any collateral contracts, must all of the forms be attached to the Franchise Disclosure Document?

ANSWER

In some cases, attaching every variation of a collateral contract that a franchisee must sign as part of a franchise purchase may unduly clutter the Franchise Disclosure Document and discourage review of the Franchise Disclosure Document by prospective franchisees. If there are variations in a particular type of collateral contract (e.g., loan agreements that vary state by state) a sample document will suffice. If there are any material differences in the contracts, those differences should be disclosed in the text of the Franchise Disclosure Document or in state specific addenda.

24.1 *Amendments*

QUESTION

The amended FTC Franchise Rule requires that, if there are material changes, a franchisor should amend the Franchise Disclosure Document within a reasonable time after the end of each calendar quarter. Will the states follow the same approach?

ANSWER

No. A franchisor should refer to individual state franchise laws on this issue. Under some state franchise laws, a franchisor must amend the Franchise Disclosure Document promptly upon the occurrence of a material change. Under state franchise antifraud laws, if there are material changes to a franchisor's franchise offering, a franchisor may not distribute its Franchise Disclosure Document to any prospective franchisee if that Franchise Disclosure Document does not include disclosure of those material changes. As a practical matter, if a franchisor is registered in a state and experiences a material change, the franchisor need not amend its registration if it does not intend to, and does not, make any additional offers or sales over which that state has jurisdiction.