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INSIDE THIS EDITION

Avoiding Comments When Preparing FDDs in 2009: Top Twelve Traps

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For most franchisors, the always-festive holiday season is followed all too closely by the not-so-festive franchise renewal season. The goal of this article is to lessen those "Bah! Humbug!" feelings about the renewal season by offering some tips that should help reduce the length of those comment letters no one enjoys, franchisors, franchise lawyers and state examiners alike. These tips should also help improve the overall disclosure provided to prospective franchisees, furthering the stated purpose of the Rule to provide the material information necessary to make an informed purchasing decision, as well as alert their attorneys to what state examiners expect to see in FDDs under the Amended Rule.

Franchisors with recent fiscal year ends are, or soon will be, preparing their annual franchise renewal filings and, for most, it will be only their second year filing franchise disclosure documents ("FDDs") under the amended FTC Franchise Rule ("Amended Rule"). Last year at this time, the Amended Rule was still relatively new and franchisors, franchise lawyers and state examiners were grappling with how to interpret many aspects of it. This year, however, things are different. Not only do franchisors and state examiners have the benefit of one year of practice, many excellent seminars and workshops on the Amended Rule, and lively exchanges on the listserve, but the FTC and the North American Securities Administrators Association ("NASAA") have provided helpful additional guidance.

The FTC has continued to post on its website (http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml) its responses to frequently asked questions ("FTC FAQs") on the Amended Rule and, in May 2008, the FTC published its much-anticipated compliance guide ("Compliance Guide"). In addition, NASAA published franchise registration and disclosure guidelines that took effect on July 1, 2008 ("NASAA Guidelines"), and, in September 2008, NASAA issued a proposed draft of its commentary to the Amended Rule ("NASAA Commentary"). Although NASAA had not finalized the NASAA Commentary as of the date the authors submitted this article, it will likely be similar to the draft version.

Taking into account all of the clarifications that the FTC, NASAA and state examiners have provided, as well as experience gathered from our firm and other practitioners, this article highlights some potential disclosure traps to help franchisors better comply with the required disclosures under the Amended Rule and avoid comments from state examiners in 2009.

1. Item 3 - Franchisors Must Disclose All *Material* Civil Actions. The Amended Rule requires that franchisors make certain disclosures in Item 3 if a franchisor was "held liable" in a civil action involving certain allegations. Franchisors have been uncertain whether they had to disclose all actions or only material actions. The NASAA Commentary answers the question by requiring disclosure of completed civil actions only if a franchisor is required to pay a material amount or provide material other consideration, or if a franchisor's rights are materially restricted. (NASAA Commentary 3.5.) In addition, franchisors must not forget to disclose

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all material civil actions involving the "franchise relationship" filed during the previous fiscal year, even if a franchisee (and not the franchisor) brought the action and the action does not allege a violation of franchise, antitrust or securities law, nor allege fraud, unfair or deceptive practices or comparable allegations (for example, a simple breach of contract claim). Further, if a franchisor discloses predecessor litigation and the predecessor is no longer affiliated with the franchisor, the franchisor must make a good faith effort to obtain updated information from the predecessor, court documents or other public sources. If a franchisor is unable to obtain that information, it may note that fact in Item 3. (NASAA Commentary 3.2 and Compliance Guide, pg. 39.)

2. Item 8 - Do Not Disclose an Officer's Indirect or *De Minimis* Interest in a Supplier. Item 8 of the Amended Rule requires franchisors to disclose whether its officers own an interest in a supplier. Franchisors need only disclose material interests and do not need to disclose an officer's interest in a mutual fund or similar investment vehicle where the officer does not have control over the investment. (FTC FAQ #18 and Compliance Guide, pg. 53.) In addition, franchisors do not need to identify the specific officers that own an interest. However, franchisors cannot use an overly general disclosure, such as "one or more of our officers own an interest in one or more of our suppliers." A similar statement referring to a *de minimis* interest may also receive a comment. It is interesting to note that, under the Compliance Guide, the term "officer" should include any person with management or policy-making authority, which extends the disclosure obligation beyond just the actual officers of the franchisor.

3. Item 11 – Disclose Trainers' Relevant Experience. Though it seems efficient, it may not be enough to simply refer to Item 2 as a means for describing the experience of a trainer in Item 11. The trainer's experience must include both the length of relevant experience in the field and with the franchisor, which may not be described sufficiently in Item 2. Alternatively, based on a welcome FTC clarification, if a franchisor's training staff is large or changes frequently, the franchisor can provide a general description of the background and experience of the staff, instead of providing the background and experience of every member of the training staff. (Compliance Guide, pg. 68.)

4. Item 12 – Use the Required Language Only When No Exclusive Territory is Granted. There has been some confusion among franchisors as to when they must include the required, boilerplate disclosure regarding an exclusive territory. If a franchisor does not grant any protected territory (for example, the franchisor grants a site-only franchise), it is clear that a franchisor must include the disclosure. It also is clear that the disclosure is not required if a franchisor grants a territory that is completely exclusive. In many instances, however, the issue is not so black and white, and a franchisor may reserve certain rights to itself within a limited protected territory. For example, a franchisor may promise not to put an identical business under the same mark in the franchisee's territory, but carve out the franchisor's right to distribute its products or services through alternative channels of distribution or operate similar businesses at special sites, such as universities, airports or stadiums. Is the boilerplate disclosure necessary in those situations? The FTC FAQs clarify that issue stating that no disclosure is necessary if franchisors simply reserve the right to use alternative channels of distribution or develop competitive brands. (FTC FAQ #25.) On the other hand, if a franchisor operates a similar business under the same marks, even from special sites such as universities, airports or stadiums, the franchisor must include the boilerplate disclosure. (FTC FAQ #25.)

5. Item 17 – Delete the Franchise Relationship Law Cites. In the past, franchisors were required to include citations to different state franchise relationship laws immediately following the Item 17 chart. This reference is no longer necessary and franchisors must delete the citations in Item 17. (NASAA Commentary 17.1.)

6. Item 19 – FPRs: Draft Carefully and Understand the Limits. Financial performance representations ("FPRs") continue to attract comments. Here are some tips to avoid those comments and to help eliminate later Franchisee actions:

- The Amended Rule requires franchisors that make an FPR to provide a "clear and conspicuous admonition that a new franchisee's individual results may differ from the results stated in the financial performance representation." The FTC and NASAA provide franchisors with form language to use to express this admonition. (Compliance Guide, pg. 92 and NASAA Commentary 19.3.)

- On the other hand, franchisors may not include warnings or disclaimers in the FPR that disclaim the information provided or state that the franchisee may not rely on the information. (NASAA

Commentary 19.3.) This is not to say, however, that franchisors should discontinue the practice of including clarifying "notes" in FPRs that detail how the circumstances of the units described in the FPRs may be different than new franchised units. As a result, franchisors must draft FPRs carefully to provide full disclosure to a prospective franchisee, adequately protect themselves, and avoid comments by not including prohibited or what some examiners believe are inappropriate warnings or disclosures.

- Similarly, franchisors should avoid using bold or all capitalized letters in FPRs unless specifically required because some examiners take issue with this practice.

- Costs, standing alone, are no longer included within the definition of FPRs. If a franchisor discloses costs outside of an FPR, it should be remembered that the franchisor may not express those expenses as a percentage of revenue. (NASAA Commentary 19.1.)

- For franchisors that elect not to provide an FPR, franchisors must include the disclaimer provided in Item 19 under the Amended Rule and nothing more.

- If franchisors use data from a subset of franchisees for their FPR, they must also clearly state the total number of franchisees in the system during the time period the data was collected.

7. Item 20 – Include all Tables and Disclose All Franchisees. The FTC and NASAA also have provided franchisors with clarification on the disclosures required under Item 20:

- In addition to the list of operating franchisees as of fiscal year end, franchisors must provide a list of those franchisees who have signed a franchise agreement but who are not operating a franchise. However, this information should only be included in Table 5 under the heading "Franchise Agreements Signed But Outlet Not Open." (Compliance Guide, pg. 102 and FTC FAQ # 19.)

- The franchisee lists must be grouped alphabetically by state, and then alphabetically by city, within each state. This requirement applies to both the list of current franchisees and former franchisees. (NASAA Commentary 20.5.)

- All Item 20 tables must be included even if there are no franchises operating. It is sufficient to simply include the "Total" row with zeros. In addition, franchisors should delete the rows for states where they have nothing to disclose. (NASAA Commentary 20.8 and 20.9.)

8. Item 20 – Include Subfranchisors, but Exclude Area Developers. Subfranchisors (or master franchisees) must include two sets of Item 20 tables – one set that includes the subfranchisor's outlets only and one set that includes all of the outlets in the franchise system. (NASAA Commentary 20.4.) On the other hand, franchisors that have area developers (or multiple unit franchise agreements) do not need to include separate charts for the area developers. (NASAA Commentary 20.2.)

9. Item 20 – State Whether There Are Confidentiality Agreements and Define Confidentiality Agreements Narrowly. In Item 20, franchisors must state whether or not franchisees have signed confidentiality clauses during the last three fiscal years. If franchisees have signed confidentiality clauses, then franchisors also must include the required disclosure under the Amended Rule. (NASAA Commentary 20.10.) The Compliance Guide also provides guidance on what is considered a confidentiality agreement and instructs franchisors to define "confidentiality agreements" narrowly. In addition to clauses designed to protect a franchisor's trademarks or operations manuals, a franchisor may exclude confidentiality clauses designed to keep the terms of a settlement confidential but do not otherwise restrict a franchisee's ability to discuss its experience in the franchise system. (Compliance Guide, pg. 108.)

10. State Quirks – Don't Assume All States Are the Same. Although the FTC and NASAA have provided franchisors with significant clarification on the interpretation of the Amended Rule, it is important to keep in mind that many of the franchise registration states still have distinct and sometimes unique requirements, such as the following:

- Although the NASAA Guidelines state that the registration states want the FDDs filed with both hard copies and electronic copies on CD-Rom, some registration states will accept a hard copy only and some want only an electronic copy on CD-Rom. (NASAA Guidelines, pg. 2.) For example, California, New York, Virginia and Washington still accept only paper copies of the FDDs (although California and Virginia also accept an electronic copy on CD-Rom in addition to the paper copy). In contrast, Rhode Island and Indiana only want electronic copies of the FDDs on CD-Rom.

- Similarly, the registration states continue to differ on the number and types of FDDs required. For example, when a franchisor renews in Maryland, it must submit complete clean and redlined copies of the FDD (both hard copies and electronic copies on CD-Rom). In contrast, Minnesota wants only a redlined copy of the FDD (both hard copy and an electronic copy on CD-Rom). (NASAA Guidelines, pg. 2.)

- The signature documents and filing forms NASAA created are accepted by the registration states, but certain states, including California, Hawaii, Minnesota, New York and Washington, still want all signature documents notarized. (NASAA Guidelines, pgs. 7-14.)

- While the FTC Rule eliminated the need for franchisors to disclose information about brokers in Item 2, many states require that franchisors submit franchise seller forms for brokers, including California, Illinois, Maryland, Minnesota and Rhode Island. As a result, franchisors will continue to struggle with obtaining and submitting franchise seller forms for large broker networks. Also, if a franchisor plans to use a broker, it is important not to forget the broker warning on the state cover page. (NASAA Guidelines, pg. 17.)

- Be sure that the receipt pages include the state-specific disclosure periods, which include the list of states that still require a 10 business-day waiting period or require that franchisors provide the FDD at the first personal meeting. (NASAA Guidelines, pgs. 25-26.)

- If you are filing in Virginia, remember that Virginia requires a slight modification to the cover page and the receipt pages; the language must say "in connection with the proposed franchise sale *or grant*." (Emphasis added.)

11. Integration Provisions – Do Not Disclaim Representations in the FDD. Franchisors should review the integration provision of their franchise agreements and any closing acknowledgments or questionnaires to ensure that they do not disclaim, or require a prospective franchisee to waive reliance on, any representation made in the FDD (including exhibits). It is not sufficient to put a modified integration clause in the state addenda as the FTC and state examiners view the limitation on the scope of any integration clause to be a requirement under the Amended Rule and not a state-specific requirement.

12. General Observations – Follow the Amended Rule in Both Substance and Form. In addition to the guidance above, it is important that franchisors keep some general observations in mind as they update their FDDs in 2009:

- Use bold text and all capitalized letters only when required under the Amended Rule.

- Franchisors must include all disclosures that the Amended Rule or a state requires, but should avoid making additional or optional disclosures. The one exception is in Item 11, where franchisors can include optional assistance if they make it clear that the assistance is truly optional. (Compliance Guide, pg. 65.)

- Use the form responses or disclosures provided by NASAA or by the FTC. In particular, NASAA has published form responses to Items 3, 4, 10 and 20. (NASAA Commentary 3.4, 4.1, 10.3, and 20.11.)

As franchisors and their lawyers prepare to file FDDs in 2009, it is important that they review them closely to ensure that they comply with the Amended Rule as interpreted by the Compliance Guide, NASAA Commentary and NASAA Guidelines. It is clearly a mistake to think that just because state examiners did not comment on a particular section of an FDD last year, no comments will be received on that same section this

year. By taking the time to review these resources and the tips outlined in this article, franchisors can lower their chances of receiving comments, saving themselves (and state examiners) the cost and frustration of dealing with lengthy comment letters, and, in many cases, provide even better disclosure to prospective franchisees.

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