

LEGALINES

Amended FTC Franchise Rule Affects Franchisees: Right of Franchise Association Disclosure Takes Effect in '08

by Peter Silverman,



On January 23, 2007, the Federal Trade Commission ("FTC") issued amendments to its Franchise Rule (16 C.F.R. § 436) (the "Amended Rule"), which had been in place since 1978. One provision of the Amended Rule — the requirement to disclose independent franchisee organizations -- is of particular interest to franchisee associations, but associations should also familiarize themselves generally with the overall changes. I review some of the key changes in this article.

A New Term

Be prepared to rid your vocabulary of the poetic phrase, "Uniform Franchise Offering Circular," and its naughty-sounding acronym, "UFOC." The Amended Rule requires franchisors to issue a "Franchise Disclosure Document," or as it will come to be known, an "FDD." States may add requirements consistent with the Amended Rule, but the Amended Rule's requirements for the Franchise Disclosure Document will govern all disclosures.

Timing

The FTC is phasing in the Amended Rule. Franchisors have been allowed to use the FDD since July 1, 2007, but must do so before July 1, 2008.

A Few Requirements of General Interest

You may not notice many substantive differences between the FDD and the UFOC. The changes, for the most part, are technical and are aimed at recognizing new technologies, reflecting changes in the marketing of franchises, and harmonizing the federal rule with state franchise disclosure laws. A few of the changes, though, are of general interest for associations.

One of the changes relates to tightening the standard for disclosing litigation. By way of background, under the UFOC guidelines, when franchisees bring suit, the franchisor needs to disclose the action and the result under certain circumstances. This is designed to help prospective franchisees understand the system. This disclosure requirement has also served as a tool for associations and their members in making strategic decisions whether to file suit; and, if so, what types of claims to include; and, in resolving disputes, the types of terms to include and whether to agree on confidentiality. The Amended Rule addresses all these issues.

Under the Amended Rule, three standards for disclosure are worth noting. Franchisors must disclose litigation (1) that involves claims "alleging a violation of franchise, antitrust or securities law, or alleging fraud, unfair or deceptive practices or comparable allegations;" (2) that is "material in the context of the number of franchisees and the size, nature, or financial conditions of the franchise system or its business operations;" or (3) in which the franchisor "was a party to any material civil action involving the franchise relationship."¹ The franchisor must disclose resolved suits unless it was not found liable² or, in a settlement, unless it did not pay any material consideration or is not bound by obligations that are materially adverse to its interests.³

If the franchisor is obligated to disclose a settlement, it must disclose all material settlement terms, and may not avoid disclosure by entering into a confidentiality agreement.⁴

A second change worth noting is that the Amended Rule has eased up the limitations on making what is known under the UFOC guidelines as an earnings disclosure, but is now referred to in the Amended Rule as a "financial performance representation."⁵ While it is too early to tell, the hope is that more franchisors will make financial representation disclosures in their FDD, which would allow prospective franchisees more information on which to base their decisions.

The Requirement to Disclose Franchisee Associations

For franchisee associations, the biggest change in the Amended Rule is that franchisors are required to disclose whether they have an independent franchisee association, and to provide contact information for the association.⁶ For an independent association to qualify, it must meet two requirements. First, it must be "incorporated or otherwise organized under state law."⁷ According to the official report explaining the Amended Rule, AAFD chapters qualify as being incorporated or otherwise organized under state law.⁸ Second, on an annual basis, associations must, request the franchisor to include the

continued on page 14

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Continued from page 8

independent association disclosure by submitting a request no later than 60 days after the close of the franchisor's fiscal year.⁹

Action Items

First, associations should write their franchisors to formally request inclusion in the franchisor's franchise disclosure document. Make sure to send the letter on your association letterhead and have an appropriate officer sign the letter. Send the letter with some form of proof of delivery, preferably by certified mail with a return receipt. The letter should include the following sample request:

Sample Request for FOA Disclosure in your franchisor's Franchise Disclosure Document

Pursuant to C.F.R. §436.5(t)(8), we request that [franchisor's name] disclose [name of franchisee association] in its franchise disclosure document. [Franchisee association] is organized as an active chapter of the American Association of Franchisees and Dealers ("AAFD"). The AAFD is an approved not-for-profit trade association organized as a trust under the laws of the State of California on May 1, 1992. The AAFD is approved as a 501(c)(6) tax-exempt trade association under federal law, and is approved for similar status under California law. The Federal Trade Commission Report on its Amended Franchise Rule explicitly recognizes AAFD chapters as meeting the Amended Rule's requirements for mandatory disclosure. See Report at p. 15508, n. 648.

You may also want to add language that your association looks forward to working collaboratively with the franchisor.

Second, make sure to calendar the date annually to make this request no later than 60 days after the close of the franchisor's fiscal year.

Closing Thoughts

Many franchisee advocates submitted comments to the FTC as the FTC went through its rule-making process. Their efforts bore fruit. The Amended Rule should result in prospective franchisees receiving more useful information than they had been receiving under the UFOC guidelines. Further, the Amended

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Continued from page 7

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Rule's requirement to disclose associations will give associations more power to play a positive role in working with the franchisor. Since prospective franchisees will learn about the association in the FDD, and will be given contact information, prospective franchisees are very likely to call the association for comments. Franchisors will clearly benefit if their association responds to the prospective franchisee's inquiry as follows:

[Franchisor] is committed to total quality franchising. [Franchisor] treats the franchisees and the association as partners in working to make a better system, they advise us of material issues, listen to our input and allow our participation in issues and programs that affect the franchisees directly. This is a great system to join.

Or even better:

We are proud that [Franchisor] has been awarded the Fair Franchising Seal from the American Association of Franchisees and Dealers. ■

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End Notes:

- ¹16 C.F.R. § 436.5(c)(2)(i)(A and B), (ii).
- ²16 C.F.R. § 436.5(c)(1)(iii)(B)
- ³Report on Disclosure Requirements and Prohibitions Concerning Franchising, Federal Register, Vol. 72, No. 61, 15444 at 15479 n. 357.
- ⁴16 C.F.R. § 436.5(c)(3)(ii), n. 2.

- ⁵16 C.F.R. § 436.5(s).
- ⁶16 C.F.R. § 436.5(t)(8).
- ⁷16 C.F.R. § 436.5(t)(8)(ii).
- ⁸Report on Disclosure Requirements and Prohibitions Concerning Franchising, Federal Register, Vol. 72, No. 61, 15444 at p. 15508, n. 648.
- ⁹16 C.F.R. § 436.5(t)(8)(ii).

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