

1998 COMMENTARY ON THE UNIFORM FRANCHISE OFFERING CIRCULAR GUIDELINES

Adopted April 18, 1999

**(Original UFOC Commentary Restated and Supplemented with Additional
Issues)**

INTRODUCTION

On April 25, 1993, the North American Securities Administrators Association ("NASAA") adopted amendments to the Uniform Franchise Offering Circular Guidelines ("UFOC"). After adoption of the amended UFOC, the NASAA Franchise and Business Opportunity Committee (the "Franchise Committee") proposed that NASAA publish a Commentary on the UFOC. NASAA adopted that Commentary on June 21, 1994 ("1994 Commentary"). The 1994 Commentary discussed the Franchise Committee's interpretation and clarification of specific issues regarding the UFOC and its instructions. The Franchise Committee presented the 1994 Commentary in a question and answer format. The 1994 Commentary did not effect any substantive change in the UFOC Guidelines.

In the five years since the adoption of the present UFOC, the Franchise Committee has identified additional issues for clarification and interpretation related to specific UFOC items and instructions. The Franchise Committee has studied these issues for more than a year after consulting with its Advisory Committee and others in the franchise industry. The Franchise Committee has determined that a new UFOC commentary would assist franchisors and franchisees and help to achieve a more uniform interpretation of the UFOC.

The following commentary is in substantially the same format as the original 1994 Commentary. For the ease of the reader, the Franchise Committee has restated issues from the 1994 Commentary and supplemented those issues with new commentary issues. The combined commentary issues ("1998 Commentary") are presented in sequence according to the UFOC item or instruction to which they relate. Commentary issues from the original 1994 Commentary are identified with the designation "1994" and the issues number from that publication. Issues that have been added for this 1998 Commentary are identified with the designation "1998."

Instruction 265—Phase In

Question: The new UFOC is effective 6 months after the last franchise regulatory state (or the FTC) approves it, but no later than January 1, 1995. Can a franchisor begin using the new format in a state which had approved the new UFOC (and after FTC approval) but before the national effective date?

Answer: A circular prepared in accordance with the new UFOC may be used in a state after that state and the FTC have approved the new format. (FTC approval was given on December 30, 1993.) Thus, after state and FTC approval, either a new or old format circular may be used in that state. After the national effective date, only a new UFOC may be used in connection with an initial filing or renewal. **(1994 Issue #1)**

Instruction 265—Amendments

Question: If a franchisor files an amendment (for example, to change personnel in Item 2 or add litigation in Item 3) after the national effective date but before its next renewal date, is it required to change-over the entire UFOC to the new format at that time?

Answer: An amendment filing is not required to be on the new format until after the franchisor submits a new UFOC in its first renewal (or annual report) after the national effective date (however, see FTC Advisory Opinion 94-1).

It may be advisable, but is not required, for a franchisor to amend its registration before the national effective date to change-over to the new UFOC (to avoid potential delays in review and approval during 1995). Because of the nature of this type of amendment filing (that is, an amendment only for the purpose of changing over to the new UFOC), a franchisor should not have to stop offering franchises during the review period. **(1994 Issue #2)**

Instruction 265—"Re-Registration"

Question: The word "re-registration" appears in Instruction 265. What does it mean?

Answer: The word "re-registration" was intended to cover a franchisor who had been registered in the past but whose registrations have since lapsed and now is filing to become registered again. **(1994 Issue #3)**

Instruction 265—Phase-In for Non-Registration States

Question: If a franchisor has not registered its offering in any state, when is it required to convert to the new UFOC?

Answer: The FTC phase-in requirements will apply, **(1994 Issue #4)**

Cover Page—Effective Date

Question: What effective date should appear on the UFOC cover page?

Answer: The date that a state franchise registration application is made effective by an administrator should appear on the UFOC cover page (or in a separate exhibit). The FTC cover page may contain the date that the UFOC was first issued but this date should not be used on the UFOC cover page. **(1998)**

Cover Page—Risk Factors

Question: If no risk factors are required to be disclosed on the cover page, must the following language be used: "There may be other risks concerning this franchise?"

Answer: No. The above language is only required to be used in conjunction with other specific risk factors. **(1998)**

Cover Page—State Risk Factors

Question: If a state requires the inclusion of additional risk factors, must they be added to all UFOCs 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. As a general rule, state franchise laws have no extraterritorial effect and the requirements of one state should not automatically be imposed on a franchisor's offers in another state. (1998)

Item 1—"Predecessor" Definition

Question: Is the definition of "predecessor" in instruction iii of Item 1 applicable to Item 1 only or is it applicable throughout the UFOC, for example, to the use of "predecessor" in Items 3 and 4?

Answer: The definition of predecessor in instruction iii of Item 1 should be applied throughout the UFOC. (1994 Issue #5)

Item 1—Predecessor—Change of Ownership

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

Answer: A change in ownership of a franchisor does not necessarily mean that the former owner is a "predecessor." A former owner must be disclosed as a predecessor only if the franchisor acquired the majority of its assets (calculated as of the date of acquisition) from that former owner. (1998)

Item 1—Predecessor Disclosure Period

Question: Is the ten year period regarding predecessor disclosure in the instruction iv to Item 1 applicable to Item 1 only or is it also applicable to predecessor information in Items 3 and 4?

Answer: The ten year period referred to instruction iv of Item 1 is also applicable to predecessor disclosure in Items 3 and 4. (1994 Issue #6)

Item 1—"Affiliate" Definition

Question: What definition of "affiliate" should be used in the new UFOC?

Answer: As a general rule in the new UFOC, an "affiliate" is "a person (other than a natural person) controlled by, controlling or under common control with the franchisor." This definition applies to all Items unless a particular Item defines it differently or limits its use. For example, Item 1, instruction v, limits the general definition to an affiliate "which is offering franchises in any line of business or is providing products or services to the franchisees of the franchisor." Also, Item 3, instruction i, limits the general definition to an affiliate "offering franchises under the franchisor's principal trademarks." (1994 Issue #7)

Item 1—Affiliate/Natural Persons

Question: "Affiliate" excludes natural persons in Item 1. Does the same exclusion apply throughout the UFOC?

Answer: Yes. "Affiliate" excludes natural persons throughout the UFOC. (1998)

Item 1—Foreign Affiliates

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

Answer: All affiliates, including foreign affiliates, must be disclosed in Item 1. If the list is extensive, addresses may be listed in an exhibit to the UFOC. **(1998)**

Item 1—Government Regulations

Question: Item 1E, instruction vi. refers to "regulations specific to the industry in which the franchise business operates." How broadly does this extend? How much detail is required about these regulations? For example, a restaurant franchisor might refer to food service health and sanitation codes since those are industry-focused. Child labor laws, while not industry-specific, impact on the fast food business. Should they be mentioned and, if so, what about other general laws that have a significant impact on a particular type of business format?

Answer: The instruction states that it is unnecessary to refer to laws that "apply to businesses generally." A fast food franchisor, therefore, would not be required to refer to child labor laws or other general categories of laws even if those laws have a substantial or disproportionate impact on the business being franchised. In addition, generally-applicable regulations such as local signage restrictions, no-fault liability insurance requirements, business licensing laws (as opposed to professional licensing laws), tax regulations and labor laws need not be disclosed.

Only laws that pertain solely and directly to the industry sector of which the franchised business is a part must be disclosed in this Item. Examples include:

—A real estate brokerage franchisor should disclose that broker licensing laws will apply to the franchisee.

—An optical products franchisor should disclose the existence of applicable optometrist/optician staffing regulations and licensing requirements.

—A lawn care franchisor should disclose that certain laws regulating pesticide application to residential lawns will require that franchisees post notices on treated lawns.

In any case where industry-specific laws are disclosed, statutory citation and identification are unnecessary; the disclosure should state that a specific type of regulation exists and that the prospective franchisee should investigate the matter further. **(1994 Issue #8)**

Item 2—Employment History

Question: Must the employment history of a person identified in Item 2 be limited to 5 years?

Answer: Employment history should be limited to 5 years. However, a longer period may be permissible if the extended employment history is relevant to the franchise being offered. **(1998)**

Item 3—Confidential Settlements

Question: Under the old UFOC, franchisors were not required to disclose the terms of confidential settlements. Are the terms of confidential settlements required to be disclosed under the new UFOC?

Answer: If a settlement agreement must be disclosed under Item 3B of the new UFOC, all material settlement terms must be disclosed, whether or not the agreement is confidential. However, because of difficulties in retrieving information and/or obtaining releases from confidentiality agreements, for confidential settlements entered into before April 25, 1993 (the date of NASAA's approval of the new UFOC), a franchisor may disclose only the information required under the old UFOC. **(1994 Issue#9)**

Item 3—Dismissals

Question: Based on the last sentence of section ii of Item 3, Definitions, may actions which are dismissed in the context of a settlement be omitted from Item 3?

Answer: The last sentence of section ii of Item 3, Definitions, allows the omission of an action which is dismissed as a result of a concluded adversarial proceeding, but is not intended to cover dismissal of an action in connection with a settlement. The standards for determining whether a settlement must be disclosed (or may be omitted) are described in section iv of Item 3, Definitions. **(1994 Issue #10)**

Item 3—Other Material Actions

Question: Are only actions of the types enumerated in Item 3 required to be disclosed?

Answer: The requirement that a franchisor disclose actions which include allegations of violations of franchise, antitrust or securities law, or fraud, unfair or deceptive practices, or comparable allegations should be not be narrowly construed in drafting disclosure for Item 3. Most franchise laws generally prohibit, among other things, omissions of material fact. The courts have generally interpreted "material facts" or "materiality" to include information which a reasonable investor would deem to be significant when making an investment decision. Franchisors should not limit disclosure solely to those items enumerated in Item 3 if a materiality analysis requires disclosure of an action. **(1994 Issue #11)**

Item 3—Foreign Litigation

Question: Are franchisors required to disclose foreign (outside the United States) actions in Item 3 of the UFOC?

Answer: Item 3 is not limited to disclosure of actions which have been filed in the United States. Franchisors must disclose all material litigation, even if the actions are in a foreign court or arbitration forum. **(1994 Issue #12)**

Item 3—Mediations

Question: Are mediations required to be disclosed in Item 3?

Answer: A mediation is not required to be disclosed in the UFOC, unless it results in the

settlement of litigation required to be disclosed (and the settlement is otherwise material—see Issue #10 of 1994 Commentary). (1998)

Item 3—Felonies

Question: Are felonies of all kinds required to be disclosed in Item 3?

Answer: Only felonies involving enumerated claims (for example, antitrust, securities, franchise, fraud) must be disclosed. (1998)

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 UFOC before the franchisor obtained control of the franchised business?

Answer: A franchisor must make good faith efforts to obtain updates of a predecessor's litigation but, if it is unable to obtain information, it may note this fact in Item 3. (1998)

Item 4—Bankruptcy

Question: Item 4 requires disclosure of bankruptcy information about "officers." Does this include everyone listed in Item 2?

Answer: Only "officers" are required to make bankruptcy disclosures in Item 4, not every person listed in Item 2. "Officers" includes those individuals whose duties include some or all of the duties typically performed by the chief executive and chief operating, financial, franchise marketing, training and service officers. It also includes "de facto" officers, those individuals who have management responsibility in connection with the operation of the franchisor's business relating to the franchises offered by the offering circular but whose title does not reflect the nature of the position. A member of the Board of Directors who is not also an officer (as described above) is not covered by this disclosure. (1994 Issue #13)

Item 5—Initial Fees Paid to Affiliates

Question: If the franchisee makes any payments to affiliates of the franchisor before the franchisee's business opens, must this be disclosed as an "initial fee?"

Answer: "Initial fees" include all fees and payments received by the franchisor and its affiliates before the franchisee's business opens. (1994 Issue #14)

Item 5—Fee Disclosure

Question: If a franchisor occasionally sells company-owned outlets to franchisees, does the purchase price of the outlets constitute an initial franchise fee and, if so, must it be disclosed in Item 5 and on the cover page?

Answer: If an isolated occurrence, the cover page need not reflect the purchase price. However, Item 5 should disclose these occasional sales during the preceding fiscal year and the range of amounts involved. (1998)

Item 6—Uniformity

Question: Must a franchisor disclose whether each continuing fee is uniform?

Answer: A franchisor must disclose whether any continuing fees currently being charged are uniform. It need not disclose that fees charged in prior periods are different from the current fees. (1998)

Item 6—Fees Paid to Third Parties

Question: Must a franchisor disclose in Item 6 fees or charges that franchisees are required to pay to third parties?

Answer: Fees or payments to third parties are not required to be disclosed in Item 6. However, these fees or payments typically are required to be disclosed in Items 7 or 8. Also, if the fees or payments are imposed or collected by the franchisor on behalf of a third party, they must be disclosed in Item 6. (1998)

Item 7—Initial Phase

Question: The new UFOC requires disclosure of certain information during the "initial phase" of operation of the franchised business and indicates that it is ordinarily 3 months. Is the initial phase always 3 months? Or must a franchisor use a longer period if that is typical in its industry? Also, does the "initial phase" requirement apply to any line item in Item 7 other than "additional funds?"

Answer: A franchisor may use either a 3 month initial phase, or an initial phase longer than 3 months if the length of time is a "reasonable period for the industry" and if earnings claim problems can be avoided (for example, by complying with Item 19). Only the additional funds line item is covered by the "initial phase" requirement, but it may also be appropriate in some cases to disclose real estate costs during the initial phase. In addition, fees paid to the franchisor during the initial phase may be disclosed, so long as earnings claims problems can be avoided (for example, by complying with Item 19). All other expenditures, such as for inventory, should only be stated through the franchise opening date. (1994 Issue #15)

Item 7—Owners Salary

Question: Does the additional funds line item include an owner's salary or draw?

Answer: Generally no, but this exclusion should be described in a footnote to the Item 7 chart. (1998)

Item 8—Scope

Question: A variety of terminology is used throughout Item 8 to refer to a wide range of sourcing restrictions. For example, although the requirements refer to all sourcing restrictions, reference 10 is made in Instruction iii to "required purchases" and in Instruction vii to "designated" suppliers. 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. As a result, for example, Instruction iii encompasses all revenues a franchisor (or its affiliates) derives from purchases and leases of products and services to franchisees. Also, Instruction vii requires the disclosure of all rebates paid by designated suppliers, approved suppliers whose goods and services meet specifications. **(1994 Issue #16)**

Item 8—Scope Clarification

Question: In the issue discussed above (Issue #16 of the 1994 Commentary), certain language could be interpreted to require disclosure of all purchases or leases from the franchisor or its affiliates. Must a franchisor provide disclosure of all purchases or leases or only those that are "source-restricted?"

Answer: In most cases, Item 8 will require a franchisor to disclose all purchases or leases a franchisee makes from the franchisor or its affiliates. Although Item 8 covers only source-restricted purchases and leases, most franchisee purchases and leases from a franchisor will be subject to some restriction, either by contract or in practice. That is, most franchisee purchases and leases from the franchisor or its affiliates are made because they are approved suppliers, or their products meets some express or implied specifications. However, on the rare occasion franchisees may choose to purchase products from the franchisor that are not subject to any sourcing restrictions whatsoever, the franchisor need not disclose those purchases or leases in Item 8. For example, a franchisee of a fast food chain may purchase generic drinking straws from the franchisor. The franchisor need not include this purchase in its item 8 disclosure if the franchisee had total discretion to purchase straws from any source but voluntarily decided to buy them from the franchisor. **(1998)**

Item 8—Rebates for Advertising

Question: If a supplier makes payments to an advertising fund or advertising coop, must this be reported?

Answer: If the payments are made to an independent advertising co-op, disclosure is not required. Payments to an advertising fund directly or indirectly controlled by the franchisor must be reported. **(1994 Issue #17)**

Item 8—Rebates from Other Parties

Question: If the supplier of goods to franchisees is a distributor who buys from a manufacturer and the manufacturer pays rebates to the franchisor, must this be disclosed?

Answer: Rebates paid by all third parties involved in the product distribution process must be disclosed. **(1994 Issue #18)**

Item 8—Rebates to Affiliates

Question: If rebates are paid by suppliers to an affiliate of the franchisor, must these rebates be disclosed?

Answer: Rebates paid by suppliers to the franchisor's affiliates must be disclosed. **(1994 Issue #19)**

Item 8—Rebates—Identity of Suppliers

Question: Although the sample answer identifies suppliers who pay rebates, the instruction does not require such identification. Must the franchisor identify by name suppliers who pay rebates?

Answer: Franchisors are not required to identify by name any suppliers who pay rebates. (1994 Issues #20)

Item 8—Product Discounts

Question: Instruction vii indicates that a franchisor who pays less than its franchisees for products bought from a common source has received a "payment" from a supplier. Is this intended to encompass every situation where a franchisor pays less than a franchisee?

Answer: If a franchisor receives a "special deal" on the purchase of products that a vendor also supplies to franchisees, this constitutes a "payment" to the franchisor for purposes of this disclosure. It is not a payment, however, if a franchisor takes advantage of a volume discount or other program which the supplier makes available to all other buyers, including franchisees. (1994 Issue #21)

Item 8—Rebate Reporting

Question: Can a franchisor choose to report either the dollar amount of the rebates or the percentage paid on purchases by franchisees?

Answer: A franchisor can choose to report rebates in either of 2 formats: the actual dollar amounts paid or the percentage rebate based on franchisee purchases. Thus, if a number of suppliers pay rebates and a franchisor chooses the latter reporting method, its circular might state that it received rebates from suppliers ranging from 1% to 596 of the amount of purchases by franchisees from such suppliers. (1994 Issue #22)

Item 8—Cooperatives

Question: Must cooperatives be identified under Item 8F?

Answer: If a franchisee is required to participate in a purchasing or distribution cooperative, it must be identified. If participation is voluntary, it need not be identified but the franchisor must disclose that one or more cooperative exist.

Item 8—Multiple Brands

Question: If a franchisor has multiple branded outlets, should it separate each brand's revenue in Item 8?

Answer: A franchisor generally should segregate brand revenues. If it is impractical or unreasonable to segregate revenue by brand, a franchisor is not required to do so as long as it clearly discloses this fact. (1998)

Item 8—Price Terms

Question: Is a franchisor required to disclose any price terms it negotiates with suppliers in Item 8?

Answer: A franchisor is required to disclose that it negotiates agreements with suppliers and that those negotiations may include price terms. However, the specified price terms are not required to be disclosed. (1998)

Item 10—Financing Terms

Question: If financing is offered on an individually negotiated basis or on widely varying forms, what documents must be attached to the UFOC?

Answer: If there is no standard form, Item 10 itself or an exhibit must disclose the material terms of the various financing. (1998)

Item 11—Optional Services

Question: Can optional (non-obligatory) services be disclosed in Item 11?

Answer: Optional, non-obligatory services may be disclosed if they are-identified clearly as optional. (1998)

Item 11—Operating Manuals

Question: Can the table of contents (which may be lengthy if there are multiple manuals) be disclosed in an exhibit rather than in the body of text to Item 11? Also, can a franchisor require that a franchisee sign a confidentiality agreement in connection with the "viewing" of a manual?

If so, must the confidentiality agreement be attached as an exhibit to the UFOC and do the FTC waiting periods apply?

Answer: Tables of contents can be incorporated as an exhibit to the UFOC. A confidentiality agreement must be disclosed in the UFOC and the franchisor cannot require that it be signed until 10 business days have elapsed from delivery of the offering circular and 5 business days have elapsed from delivery of the execution copy of the confidentiality agreement. (1994 Issue #25)

Item II—Advertising Funds/Multiple Brands

Question: If a franchisor has multiple brands, must the advertising fund disclosures be segregated by brand?

Answer: See Answer for Issue related to Item 8 "Multiple Brands" above. (1998)

Item 11—Advertising Fund/Allocation of Production Expenses

Question: A franchisor must account for its use of monies in the advertising fund by providing a disclosure which allocates dollars to production, media costs, administrative expenses and other. If franchisor personnel are involved in production activities, can such

expenses be allocated to production rather than administration?

Answer: A franchisor's internal costs associated with production of advertising materials may properly be characterized as production expenses. However, the franchisor must have a reasonable basis for claiming the allocation at the time disclosure is made. **(1994 Issue #24)**

Item 11—Advertising Fund/Allocation of Salary Expenses

Question: If an advertising fund pays all or part of the salaries of certain franchisor personnel involved in advertising production, is this a production or an administrative expense?

Answer: Either characterization is acceptable as long as the UFOC explains the allocation. **(1998)**

Item 11—Training

Question: If the franchisor's training staff is large and/or changes frequently, can a franchisor use a general description of the background and experience of the staff?

Answer: Yes, but the corporate officer in charge of training, if any, should be disclosed here (along with information about his or her experience) or in Item 2. **(1998)**

Item 11—Computers

Question: How much detailed information must be disclosed about computer hardware and software?

Answer: The disclosure must contain enough information to allow the prospective franchisee to comparison shop the items involved. If computer system components change frequently, an amendment is necessary only if a material cost item or a material change in cost is involved. **(1998)**

Item 15—Agreements by Owners

Question: Does Item 15 require the disclosure of all agreements that apply to the franchisee's owners?

Answer: All agreements relating to the franchise that are binding on the franchisee's owners must be disclosed in this Item. **(1994 Issue #26)**

Item 17—Tables

Question: Can one table be used with separate columns for each agreement?

Answer: If the table is clear, concise and useful to the reader, one table may be used. **(1998)**

Item 20—Subfranchise/Area Development Statistics

Question: Does Item 20 require disclosure of data regarding area development, master franchise, subfranchise and similar arrangements in addition to unit/outlet franchise statistics?

Answer: All area development, master franchise, subfranchise or similar arrangements must be disclosed in Item 20 of the franchisor's offering circular. If there are only a few arrangements like this in a system, the disclosure may be provided in the text or in a subordinate table rather than in the main chart.

Whatever format is used, it must include all of the information which would be required in the chart. **(1994 Issue 27)**

Item 20—System Statistics in Subfranchisor Offering Circulars

Question: In an offering circular prepared by a subfranchisor in a particular region, must its Item 20 also reflect national statistics for the franchisor in addition to the statistics from the subfranchisor's region?

Answer: In the example, Item 20 must contain 2 sets of charts: one set for statistics from the subfranchisor's region and one set reflecting national data for the franchise being offered by the franchisor and other subfranchisors. **(1994 Issue #28)**

Item 20—Subfranchise Information

Question: What data must a subfranchisor include in Item 20?

Answer: The subfranchisor's UFOC must include all of the required charts describing the status of subfranchisor-owned units and its subfranchisees' units. In addition, the subfranchisor's UFOC must include parallel charts for the franchisor, which consolidate the information compiled from all of the subfranchisors (and other franchisees) across the U.S. The lists of current and former franchisees need only cover the subfranchisor's own subfranchisees. **(1998)**

Item 20—International

Question: Must international outlets be listed?

Answer: A franchisor is permitted to include a list of international outlets, but is not required to do so. **(1998)**

Item 20—Former Franchisees

Question: Item 20E requires a list of home addresses and phone numbers of former franchisees. Can a franchisor answer this to the best of its knowledge? If the former franchisee is a corporation, is the corporate headquarters a home address?

Answer: A franchisor must disclose the last known home address of a former franchisee. Where the former franchisee is a corporation, the franchisor must disclose either the business address of the corporation or the address of a principal officer of the corporation. **(1994 Issue #29)**

Item 23—Receipt

Question: Where should the receipt be placed?

Answer: The receipt pages should be placed at the very end of the entire package given to the

prospective franchisee. (1998)

CONCLUSION

The UFOC is intended to be a living document that provides interpretative assistance to members of the franchise community and regulatory authorities. This 1998 Commentary is intended to provide guidance on issues that have raised questions of interpretation. The Franchise Committee has approached this project with the goal of making the UFOC a guide for clear and sensible disclosure of all material information that a prospective franchisee needs in order to make an informed decision before buying a franchise.

The 1998 Commentary is a product of the cooperative efforts of the current and past members of the NASAA Franchise Committee and our Advisory Committee. We look forward to a continuing dialog with all members of the franchise community.

NASAA Franchise and Business Opportunities Committee