

# Hey, Get a Clue!

Find out why the Uniform Franchise Offering Circular has been a franchisee's best friend for 25 years.

Andrew A. Caffey | January 1, 2004

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If you're seriously considering purchasing a franchised business, you have a marvelous advantage over buyers of independent businesses: You receive a Uniform Franchise Offering Circular (UFOC) from the franchisor at least a couple of weeks prior to closing on your purchase. This document is designed to make your franchise investment a fully informed decision, and for prospective franchisees, it's worth its weight in Big Macs.

Since 1979, federal franchise law has required franchisors in the United States to deliver this document to all prospective franchisees. The fundamental pre-sale disclosure approach to franchise sales regulation hasn't changed in 25 years, but the UFOC has changed considerably over that time.

Here's what hasn't changed: The UFOC is still a sandwich of three important components: 1) a 23-item narrative disclosure describing various aspects of the franchise offering, 2) up to three years of the franchisor's audited financial statements, and 3) the franchise agreement form and other contracts you're required to sign to become a franchisee.

The UFOC was actually written and first published in 1975 by the Midwest Securities Commissioners Association, predecessor to the group that now periodically reviews and publishes the UFOC, the North American Securities Administrators Association. The disclosure format was created in response to the disparate disclosure requirements that an increasing number of states were adopting in the early 1970s. Since then, the UFOC has been embraced by all the state and federal authorities regulating franchising in the United States, and it has been imitated by a dozen different countries around the globe that now regulate franchise sales.

This author was just emerging from law school and testing his wings as a

lobbyist for the franchise community. At about the same time, the FTC was considering its now well-established Franchise Rule, which requires delivery of a disclosure document for every franchise transaction in the country.

Within the 25 years since the FTC adopted it, the UFOC has helped countless investors, and regulators have tweaked its design so it's an even better investor tool than when it was originally designed. In that time, I have written dozens and dozens of UFOCs for my franchisor clients, and I've always felt some sections of the UFOC contained vital investor information, while others were less important. I'm also convinced key pieces of information about the franchise and its systems do not appear in the UFOC. It's by no means a perfect document and should not be relied on to the exclusion of other research steps that all franchise investors are well-advised to take, such as interviewing existing franchisees.

Still, in 2004, it has never been more important to carefully review and understand the UFOC before buying a franchise. It may be cold comfort as you sit down to read this thick prospectus, but you're far better off than a 1979 investor in at least one important aspect: Since the 1993 revisions to the UFOC guidelines, the disclosure documents must be written in "plain English." In the past decade, an entire generation of franchise attorneys (including yours truly) had to break a lifetime of outdated UFOC writing habits. It wasn't pretty. To give you an idea of what my colleagues and I were up against, the 1993 plain-English rules prohibited the use of any word or phrase appearing on a long list of 60 "legal antiques," which included obvious legalisms such as "condition precedent," "hereinafter," "heretofore," but also included some perfectly serviceable (and plainly understood) words and phrases such as "commence," "so long as," "relating to," "on behalf of" and "prior to." In the 1990s, armed with this list, state franchise examiners became scolding schoolmarms fussing over the banned words and phrases, with franchise attorneys as their reluctant pupils.

In desperation, some California franchise regulators started requiring submission of the word processing file of the UFOC narrative so they could pull it up and, with far too much relish, edit out all the passive voice writing and specific legalese that the new UFOC guidelines banned. They would

then e-mail back your UFOC, bleeding from every section with redlined revisions. But the result is a document that's far more readable in 2004 than the turgid tomes we turned out in the 1980s.

## Breaking It Down

Let's take a closer look at the more important sections of the UFOC:

- **Items 1 through 4** describe the franchisor and provide an overview of the franchise offering and the laws and regulations that directly affect your franchised business. You'll find a list of key franchisor executives and directors in Item 2, and Item 3 reveals the 10-year litigation history of the franchisor, its affiliates and the people listed in Item 2. Item 4 discloses any bankruptcies of the franchisor and its officers. The modern version of the UFOC is broader in litigation scope than the early versions and includes arbitration proceedings as well as traditional court cases and agency actions.
- **Items 5, 6 and 7** give you a good idea of the costs and fees typically incurred by franchise investors in the program. Items 5 and 6 cover fees paid to the franchisor, and Item 7 is a valuable chart summarizing the overall costs of establishing a new business. This chart has served as the heart of the UFOC since its first iteration and is a very useful tool for the investor.
- **Item 8** is the most difficult section of the UFOC for the franchisor's legal team to write, and it tends to draw the most attention from examiners reviewing the UFOC. This item requires disclosure of the limitations and dynamics of product sourcing and product specifications by the franchisor. Read this section carefully, and make sure you understand the limitations on your purchase of inventory and equipment.
- **Item 9** is a relatively useless cross-reference chart showing where a list of "Franchisee's Obligations" is addressed in the narrative items and the franchise agreement. Charts became big in the 1993 version of the UFOC. By then, we all had word processing software that could actually create a chart.
- **Item 10** tells you about any financing the franchisor provides, a rarity in franchising. When a very sophisticated franchisor does offer financing, the details this section demands make it nightmarish to write (translating the dense legalese of banking documents into

breezy UFOC-style plain English is nearly impossible), and reading the item is guaranteed to make your eyes slam shut. I've found the UFOC is geared well for straightforward franchise businesses but is woefully inadequate for the franchisor in a highly technical and complex business (such as our major client offerings in the petroleum and telecommunications industries). No allowance is made for a highly sophisticated offering to huge "franchisee" organizations with teams of in-house lawyers, and several states have no exemptions that offer relief from registration review.

- **Item 11** describes the "Franchisor's Obligations" and is the longest, most illuminating and most exasperating section of the venerable UFOC. It's effectively a translation (plain English, please) of the major portion of the franchise agreement and pins down the franchisor on any number of service-related subjects. If the franchisor is short or long on contractual obligations to its franchisees, it will be evident as you read Item 11.
- **Items 12, 13 and 14** detail the intangible rights you receive as a franchisee: trademarks, patents, confidential information and territorial rights around your business location. The older versions of the UFOC listed virtually all trademarks associated with the program; now just the principal marks are disclosed. The territorial description in Item 12 can be tricky and easily misunderstood, so read it carefully and go over it with your legal counselor.
- **Item 17** is a useful multipage chart that cross-references and summarizes provisions of the franchise agreement on the topics of "Renewal, Termination, Transfer and Dispute Resolution." This streamlined, insightful disclosure item replaces the worst of the prior format: a complete regurgitation of huge slugs of legalese from the agreement. Breeze through the chart in Item 17, and count your blessings.
- **Item 19**, disclosing "Earnings Claims," has seen the most radical changes in the UFOC's 25 years. The rule is this: The franchisor can't talk about the future earning potential or past performance of its franchisees unless the information is presented here in Item 19, appropriately footnoted with its bases, assumptions and limitations.

In past versions of the UFOC, franchises found it far more difficult to comply with the disclosure standards in this item. This series of changes has been driven by a shift in the underlying policy consensus on the use

and disclosure of earnings information. In the '70s, regulators reacted to the most flagrant abuses in the franchise marketplace: the wild and unfounded claims about the money to be made in a franchised business. The early versions of the UFOC made disclosure compliance so difficult, only a few brave franchisors even attempted it. Through the '80s and '90s, that regulation has loosened, simplifying the disclosure requirements and allowing ease of compliance, so now a healthy percentage of franchisors (the best estimates put it at more than 25 percent) include earnings information in their documents. The states have seriously considered requiring franchisors to include earnings information in the UFOC. That hasn't happened yet, but it sure tells me the pendulum has made a remarkable full swing over the past 25 years on this single most sensitive issue in franchise regulation. Read this item carefully, and make sure you understand the information (if there is anything there).

- **Item 20** gives you complete statistical information about the expansion or contraction of the franchise system over the past three years as well as projections of the states in which franchise sales will occur in the coming year. The franchise stats are reduced to a complicated, dense little chart that's difficult to read, but at least it's all in one place. This section also contains full lists and contact information for existing franchisees and those who left the system for any reason in the past year.
- **Item 21** contains the franchisor's audited financials. Plan to take them to an accountant who can evaluate them and tell you about the strength or weakness of the company's financial status.
- **Finally, Item 22** provides samples of all the contracts you'll be asked to sign. These are not required to be in plain English and may be difficult to understand. Ask an experienced attorney to look them over and explain them to you.

The UFOC is aging well, and 25 years later, it's still smoothing the way for franchise investors. The next step for the time-honored document is the leap into electronic disclosure, but that has been slow in coming. Maybe the regulators don't want to mess with a solid, reliable success story.

*Andrew A. Caffey is a franchise attorney in the Washington, DC, area and is author of [Franchises & Business Opportunities](#).*