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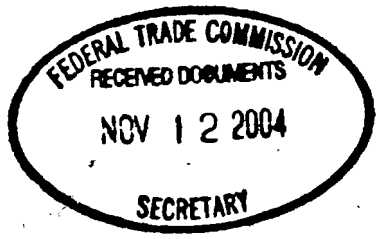
November 11, 2004



Mr. Donald S. Clark
Secretary
Federal Trade Commission
Room H-159 (Annex W)
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580

Re: Franchise Rule Staff Report

Dear Mr. Clark:

This firm is pleased to submit comments on the proposed revised trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising" ("Revised Rule") that was contained in the Staff Report of the Bureau of Consumer Protection dated August 2004. As the public record in this proceeding demonstrates, our firm has been a very active participant in this rulemaking process, appearing as witnesses and panelists in a number of public forums and submitting several comments during prior public comment periods. Indeed, this firm has been engaged in the Commission's development of a policy toward franchising since the outset, testifying during the first public hearings in the early 1970s. We are pleased to provide our firm's comments now on the Revised Rule.

The Revised Rule and its accompanying Staff Report reflect the deliberate, thorough, and thoughtful effort by the FTC staff, and we have no fundamental disagreements with the proposed revisions from the current franchise rule. For this reason, this comment will focus on seven provisions of the proposed Revised Rule which we recommend should be modified, and 11 provisions which we recommend should be clarified in the Compliance Guidelines which the Staff Report indicates will accompany the Revised Rule.

Recommended Modifications to Revised Rule

1. 436.5 (c) (1) (iii) (B) (Item 3): The Revised Rule would require the disclosure of completed actions in which the franchisor has "been held liable in a civil action or been a defendant in a material action" which alleged one of the types of claims listed in the disclosure requirement. Since a franchisor cannot be "held liable" unless it was a defendant, the phrase "been a defendant in a material action" is redundant and unnecessary to ensure disclosures of actions in which a franchisor has been held liable. Beyond that, we do not see the need for, or benefit of, disclosures based solely on the fact that the franchisor was named as a defendant. Indeed, in footnote 334 of the Staff Report, staff appears to share this view, by stating that

"franchisors need not disclose ... actions dismissed without liability or entry of an adverse order." While staff's proposed solution to this inconsistency is to insert language in the Compliance Guidelines to disregard the need to list such actions unless, essentially, the franchisor was "held liable," we think a better solution is to delete the phrase "or been a defendant in a material action" entirely. Another alternative is to limit the required disclosure to civil actions involving the franchise relationship, as has been done at Section (c) (1) (ii).

2. 436.5 (f) (Item 6): The Revised Rule would require disclosure of all ongoing payments "that the franchisee is required to pay directly to a third party." We believe that this disclosure obligation is much too broad, since it would require a listing of all possible third-party suppliers of goods and services to the franchisee. While the Staff Report listed a few examples, the reality is that any business, franchised or not, will have a myriad of third-party suppliers with whom it does business on a continuing basis. To require a franchisor to list every possible supplier to whom the franchisee may be making payments as part of its ongoing business operations would require an extensive list which, however detailed, is unlikely to list all of the relevant suppliers. This omission could expose a franchisor to potential liability for failing to provide a complete list. Staff has already recognized the impracticality of estimating payment amounts to suppliers; we think that it is equally impractical to expect the franchisor to be able to furnish a complete list of ongoing suppliers of goods and services. Therefore, we recommend that required disclosure be limited to ongoing payments made to the franchisor or its affiliates. If the FTC believes that it is important to alert prospective franchisees about the need to pay third-party suppliers on an ongoing basis, it could do so by requiring the following caveat after the table:

> "In addition to the above-listed ongoing fees which you must pay to us and/or our affiliates, you will need to secure goods and services on an ongoing basis from many other suppliers. We urge you to carefully review with your business advisors the number, nature, and estimated amount of these other necessary ongoing expenditures."

3. 436.5 (m) (Item 13): This section requires use of the following warning whenever the franchisor lists a non-federally registered trademark: "Our trademark is unregistered. Therefore, our right to use the trademark may be challenged. If so, franchisees may have to change to an alternative trademark, which may increase your operating costs." We believe that this proposed new warning is misleading in suggesting that a federally registered trademark may not be challenged and, thus, does not present the same risk as an unregistered trademark. In fact, a federally registered trademark may be, and frequently is, challenged for a variety of reasons, such as the presence of prior trademark usage in a particular market area. The key advantage to a federal registration is the presumption of superior rights, which is the focus of the warning currently required by UFOC Item 13. While footnote 472 of the Staff Report expresses staff's "doubt [that] many prospective franchisees will understand ... the phrase 'presumptive legal rights'," the Staff Report does not cite any public comment or other evidence to support staff's concern. In view of the misleading nature of the proposed new warning, we recommend that it be replaced with either the current UFOC warning or a new warning which mentions the benefits of a federal trademark registration. One possible warning could be:

"Our trademark is unregistered. An unregistered trademark does not have as many legal benefits and rights as a trademark registered on the Principal Register. Ask your attorney whether an unregistered trademark could result in additional risk or cost to you."

4. 436.5 (s) (3) (ii) (A) (Item 19): Among the disclosures required by this section are those about "the degree of competition in the market area...." A franchisor's system may encompass outlets located in different markets, and each market may have its own unique or competitive features. If earnings information is presented on a systemwide basis, it would be extremely difficult to describe the "market," even if only a few different types of market are present. Most franchisors will probably opt for a boilerplate and essentially meaningless sentence about a "very competitive" marketplace. We recommend that this disclosure be deleted, since it can cause confusion and is very unlikely to provide any meaningful information to prospective franchisees.

5. 436.5 (u) (1) (iv) (Item 21): This disclosure requires separate audited financial statements from any "other entity that commits to perform post sale obligations for the franchisor...." We believe that this requirement will create real burdens on third parties, with little or no offsetting benefit to prospective franchisees. Even though some franchisors might use a number of third parties to service their franchisees' needs on behalf of the franchisor, including area representatives, the franchisor, nevertheless, remains liable for fulfilling its contractual obligations to its franchisees, regardless of whether it delegates its obligations to third parties. Therefore, there would seem to be little value in requiring other parties to also include their financial statements in the franchisor's offering circular. The proposed disclosure also would force many third parties to incur the cost of preparing their own audited financial statements solely because they do business with the franchisor's franchisees on the franchisor's behalf. It also will force these suppliers (many of whom are likely to be non-public companies) to disclose their confidential financial information in order to be able to service the franchise system. Even more troublesome is the added burden and expense that this new requirement would impose on a non-U.S. master franchisor that contemplates having a post-sale relationship with a subfranchisee (such as supplying some of the franchisee's inventory). In such circumstance, the master would now need to include its own audited financial statements in its subsidiary's franchise offering circular, even though (a) the non-U.S. master franchisor is only involved in a portion of the relationship between the U.S. subsidiary franchisor and the U.S. subfranchisee; (b) its U.S. subsidiary discloses its own U.S. GAAP financials; and (c) the master would incur the burden and expense of conforming its own audited statement to U.S. GAAP or other alternatives set forth in subsection (1). We fail to see what benefit other entities' audited financial statements would provide to a prospective franchisee that would justify the added burden and expense on the master (or any other third party) in securing the required audited financial statements or disclosing confidential financial information. For these reasons, we recommend that this requirement be deleted.

Moreover, there appear to be two unintended inconsistencies in the text of this section: first, the first sentence of (1) authorizes use of any one of three different audited financial statement formats, while the second sentence (after describing an exception not relevant here)

authorizes use of only one of the three formats. Second, section (1) (ii) authorizes use of an affiliate guarantor's financial statements in lieu of the franchisor financial statements, but (1) (iv) then requires a separate financial statement for a franchisor who "commits to perform post-sale obligations...." This latter requirement essentially renders section (1) (ii) meaningless, since it is highly unlikely that a franchisor will ever be in a relationship where it has no post-sale obligations to its franchisees.

6. 436.1 (w) (2) (Receipt): The Receipt would require the name, principal business address, and telephone number of "each franchise seller offering the franchise." A franchise seller is defined in Section 436.1(i) as including the franchisor and the franchisor's "employees, representatives, agents, sub-franchisors, and third-party brokers who are involved in franchise sales activities." This disclosure requirement could create an extensive list of names and addresses, especially if the franchisor utilizes the services of one or more of the franchise broker networks; conversely, we do not perceive any benefit to prospective franchisees from receiving this list, especially in the Receipt, whose purpose is solely to evidence that the franchisee received a franchise offering circular. For this reason, we recommend that this disclosure requirement be eliminated.

7. 436.10 (a): This provision includes the following sentence: "Further, franchisors may have additional obligations to disclose material information to prospective franchisees." The sentence leaves the impression that whatever additional disclosures are contemplated by the sentence must be made in the franchise offering circular. Section 436.5 details extensive and detailed disclosure obligations for the franchise offering circular, while this Section 436.10 (a) appears to propose a possible additional disclosure obligation with no parameters, no guidance, and no standards for determining the scope, substance, and/or details of the required disclosure. Thus, no matter how thorough or detailed the franchise offering circular may be, this sentence places all franchisors at risk of violating the Revised Rule by not also making whatever disclosure may be required by this open-ended and ambiguous disclosure obligation. To be sure, franchisors have an obligation to comply with the disclosure obligations contained in the Revised Rule but, at the same time, they have a right to know what those disclosure obligations are, other than as set forth in Section 436.5. We recommend that the referenced sentence be deleted, or at least explicitly state that no additional disclosures are required under the Revised Rule.

Recommended Clarifications in the Compliance Guidelines

8. 436.1 (g) (1): "Fractional franchise" definition. The Compliance Guidelines should clarify the meaning of the phrase "in the same type of business" for the two years' prior business experience pre-condition. We believe that a prospective franchisee's "qualifying" experience should be broadly interpreted to include the general industry in which the franchised business operates. The principal rationale for the exemption is that the prospective franchisee should be familiar with the business issues that will arise in operating a franchised business. This familiarity should not require experience in every facet of the franchised business; instead, experience in the same basic industry should provide the knowledge necessary to make an informed purchase decision. For example, we assume that experience in the food industry is sufficient for any food service franchise, regardless of the specific type of restaurant being

franchised. We recommend that the Compliance Guidelines clarify that this phrase be broadly interpreted.

9. 436.1 (r): "Prospective franchisee" definition. The Compliance Guidelines should clarify that the phrase "agent, representative, or employee" includes an individual on behalf of other family members (i.e., spouse, children, siblings, etc.), other general and limited partners, other members, other shareholders, and/or the individual's corporate employer. Moreover, we recommend that no separate franchise offering circular should be required for any individuals or entities who join the potential investor group subsequent to the original disclosure. Both recommendations are based on the fact that these groups work together, and it is fair to assume that everyone is privy to the same information and documents. This clarification would avoid, with no adverse impact on the Revised Rule's overall disclosure goals, potential delays based on the 14-day rule for new investors, as well as eliminate potential risk of a technical violation.

10. 436.2 (a): This section describes triggering events for the 14-day rule, and includes a franchisee signing "a binding agreement ... in connection with the proposed franchise sale." We recommend that the Compliance Guidelines clarify that a "binding agreement" refers to a franchise agreement or other agreement which commits the prospective franchisee to purchase a franchise, but not any other binding agreements, such as a confidentiality agreement that the franchisor may require before permitting a prospective franchisee to review the franchisor's manual or other proprietary information; otherwise, the parties would need to wait 14 days after signing a confidentiality agreement or other agreement before being permitted to continue with negotiations.

11. 436.5 (a) (6) (vi) (Item 1): This subsection requires "a general description of the competition, including competition from any entity in which an officer of the franchisor owns an interest." Read literally, disclosure would be required whenever the officer owns a competitor company's stock, even if the ownership is a few shares of a publicly traded company or, indeed, of a mutual fund whose portfolio includes the competitor company's stock. We recommend that the Compliance Guidelines clarify that disclosure is required only if the officer has the power to exercise control over the competitor company's business.

12. 436.5 (a) (7) (Item 1): This subsection requires a description of the prior business experience of "... any predecessors; and any affiliates that offer franchises in any line of business or provide products or services to the franchisees of the franchisor...." While a franchisor need only list affiliates during the past ten years, there appears to be no companion time limit on the past history of any listed affiliate (or predecessor). The subsection also requires the disclosure of the number of franchises sold in each other line of business by predecessors and affiliates. We recommend that any disclosures be limited to a ten-year history; moreover, since actions during any period when a predecessor or affiliate was not associated with the franchisor would not be useful to a prospective franchisee in making an informed decision about the franchisor's conduct, we further recommend that any required disclosure be limited to the period when the franchisor and a predecessor and/or affiliate were associated with each other.

13. 436.5 (c) (1) (B) (ii) (Item 3): This subsection requires litigation disclosures "involving the franchise relationship." The Compliance Guidelines should clarify the definition of a "franchise relationship." Many documents may be signed with the franchisor or an affiliate that relate to the franchise business but not necessarily to the franchise relationship, such as a lease for the franchised business premises or a promissory note. We recommend that the Compliance Guidelines clarify the meaning of "franchise relationship" to exclude potential contractual arrangements other than the franchise agreement from disclosure under this subsection.

14. 436.5 (c) and (d) (Items 3 and 4): Our recommendation in paragraph 12 about requiring disclosures about predecessors and affiliates only during such periods when they were affiliated with the franchisor also applies to the disclosures required in these Items.

15. 436.5 (h) (Item 8): This section requires disclosure about a wide range of enumerated purchase arrangements. It then adds an additional requirement to "include obligations to purchase imposed by written agreement or by the franchisor's practice." It is unclear what additional purchase arrangements are contemplated by the above quoted language beyond what is previously described in the section. In addition, franchisee purchases in conformance with franchisor specifications usually are under circumstances where a franchisor is not involved with or even knows who the franchisee's suppliers are; thus, a franchisor would have no reason to know if the supplier has a "written agreement." We recommend that the Compliance Guidelines clearly describe what relationships are contemplated, as well as provide a clear example of an appropriate disclosure. Moreover, subsection (3) requires disclosure about "[a]ny supplier in which an officer of the franchisor owns an interest." Our recommendation in paragraph 11 about limiting the scope of disclosure to companies in which the officer exercises control over the supplier's business also applies to this proposed disclosure.

16. 436.5 (t) (1) (Item 21): This subsection defines "outlet" as including "outlets of a type substantially similar to that offered to the prospective franchisee." Since a franchisor needs to provide specific numbers of outlets for the required table, it needs to have a clear standard for evaluating what is "substantially similar." We recommend that the standard for "substantially similar" be defined in the Compliance Guidelines as "doing business under the same trademark and system."

17. 436.5 (t) (2) (i) (Item 21): This subsection defines a transfer as "the acquisition of a controlling interest...." No mention is made about the treatment of transfers through asset sales. We recommend that the Compliance Guidelines describe how a transfer through an asset sale should be treated.

18. 436.8 (a) (5) (i): This section describes a new proposed exemption for large investments where the "franchisee's estimated investment ... excluding real estate costs, totals at least $1 million...." We believe that the phrase "real estate costs" should be clarified, since there are many real estate-related costs which arguably could be excluded or included when calculating real estate costs, such as leasehold improvements, trade fixtures, and site improvements like a parking lot. We recommend that the Compliance Guidelines define real

estate as the purchase price of any real property acquired to establish and operate the franchised business.

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We extend our appreciation to the FTC staff for the effort, thought, conscientiousness, and even-handedness with which they have conducted this rulemaking proceeding. Their performance has resulted in an improved franchise rule which, in turn, will benefit the entire franchise community.

Sincerely,

John M. Tifford