BILLING CODE 6750-01-P

FEDERAL TRADE COMMISSION

16 CFR Part 436

Franchise Rule

AGENCY: Federal Trade Commission.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Federal Trade Commission (the "Commission" or "FTC") is commencing a rulemaking to amend its Trade Regulation Rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (the "Franchise Rule" or "the Rule"), 16 CFR Part 436, based upon the comments received in response to its Advance Notice of Proposed Rulemaking ("ANPR") and other information discussed in this notice. The Franchise Rule requires the pre-sale disclosure of material information to prospective franchisees about the franchisor, the franchised business, and the terms and conditions that govern the franchise relationship.

The Commission invites interested parties to submit data, views, and arguments on the proposed changes to the Rule and to address specifically the questions set forth in Section H of this notice. The comment period will remain open for 60 days. All comments will be available on the public record and, to the extent practicable, placed on the Commission's Internet web site: < http://www.ftc.gov>. After the close of the comment period, the record will remain open for another 40 days for rebuttal comments. If necessary, the Commission will also hold hearings with cross-examination and post-hearing rebuttal submissions, as specified in section 18(c) of the Federal Trade Commission Act, 15 U.S.C. 57a(c). Parties who request a hearing must file within the 60-day period a comment in response to this notice and a statement explaining why they believe a hearing is warranted and how they would participate in a hearing. Parties interested in a hearing must also designate specific facts in dispute and submit a summary of their expected testimony within the comment period. In lieu of a hearing, the Commission will also consider requests to hold additional informal public workshop conferences to discuss the issues raised in this notice and the comments.

DATES: Comments must be submitted on or before December 22, 1999. Rebuttal comments may be submitted on or before January 31, 2000.

ADDRESSES: Written comments should be identified as "16 CFR Part 436 -- Franchise Rule Comment" and sent to Secretary, Federal Trade Commission, Room 159, 600 Pennsylvania Avenue, N.W., Washington, DC 20580. To encourage prompt and efficient review and dissemination of the comments to the public, all written comments should also be submitted, if possible, in electronic form, on either a 5¼ or a 3½ inch computer disk, with a label on the disk stating the name of the commenter and the name and version of the word processing program

used to create the document. Programs based on DOS are preferred. Files from other operating systems should be submitted in ASCII text format to be accepted. The Commission will also accept comments submitted to the following E-mail address: "FRANPR@ftc.gov". In addition, commenters may leave a short comment on a telephone hotline number designated for this purpose only: (202) 325-3573.

FOR FURTHER INFORMATION CONTACT: Steven Toporoff, (202) 326-3135, or Myra Howard (202) 326-2047, Division of Marketing Practices, Room 238, Bureau of Consumer Protection, Federal Trade Commission, 600 Pennsylvania Avenue, N.W., Washington, DC 20580.

SUPPLEMENTAL INFORMATION:

Section A. Background

The Commission is publishing this notice pursuant to section 18 of the Federal Trade Commission ("FTC") Act, 15 U.S.C. 57a *et seq*., and Part 1, Subpart B, of the Commission's Rules of Practice. 16 CFR 1.7, and 5 U.S.C. 551 *et seq*. This authority permits the Commission to promulgate, modify, and repeal trade regulation rules that define with specificity acts or practices that are unfair or deceptive in or affecting commerce within the meaning of section 5(a)(1) of the FTC Act. 15 U.S.C. 45(a)(1).

1. The Franchise Rule

The Commission promulgated the Franchise Rule on December 21, 1978.[1] Based upon the original rulemaking record, the Commission found a serious informational imbalance between prospective franchisees and their franchisors, enabling franchisors to defraud prospective franchisees through both material misrepresentations and nondisclosures of material facts.[2] The Commission concluded that these practices led to serious economic harm to franchisees.[3]

To prevent fraudulent franchise sales practices, the Commission adopted a pre-sale disclosure rule. The Franchise Rule does not purport to regulate the substantive terms of the franchise relationship. Rather, it requires franchisors to disclose material information to prospective franchisees on the theory that an informed consumer can determine whether a franchise deal is in his or her best interest. The Franchise Rule provides prospective franchisees with four basic types of material disclosures. First, there are disclosures about the nature of the

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1 43 FR 59614 (December 21, 1978).

2 Statement of Basis and Purpose ("SBP"), 43 FR 59621, 59625 (December 21, 1978).

3 *Id.*

franchisor and the franchise system. For example, the franchisor must disclose the business background of the franchisor and its officers, their litigation history -- including suits filed by franchisees concerning the franchise relationship -- and statistics on the number of franchisees who have left the system. Second, there are disclosures that enable a prospective franchisee to assess the franchisor's financial viability and, thus, ability to perform as promised. These disclosures include the bankruptcy history of the franchisor and its officers, as well as the franchisor's audited financial statements. Third, there are disclosures about the material costs of the franchise, as well as the terms and conditions that govern the franchise relationship. Finally, there are disclosures that enable prospective franchisees to conduct their own due diligence investigation of the franchise offering, including the names and addresses of current franchisees.

2. Initial Franchise Rule Review and Request for Comments

In April 1995, as part of its continuing review of FTC trade regulation rules, the Commission published in the *Federal Register* a request for comment on the Rule ("Rule Review Notice")[4] to determine the Rule's current effectiveness and impact. The Rule Review Notice sought comment on the standard regulatory review questions, such as the costs and benefits of the Rule, what changes in the Rule would increase the Rule's benefits to consumers, how would those changes affect compliance costs, and what changes in the marketplace and new technologies may affect the Rule.[5]

3. Advanced Notice of Proposed Rulemaking

Based upon the comments received during the Rule Review, the Commission tentatively determined to retain the Franchise Rule, but sought additional comment on possible amendments to the Rule. To that end, in February 1997, the Commission published an ANPR,[6] seeking comment on specific issues, including: (1) whether the Commission should separate the disclosure requirements for business opportunities from those for franchises; (2) whether the Commission should revise the Rule's pre-sale disclosures based on the Uniform Franchise Offering Circular ("UFOC") Guidelines promulgated by the North American Securities Administrators Association ("NASAA"); (3) whether the Commission should modify the Rule to clarify that the Rule does not reach the sale of franchises to be located or operated outside the United States, its territories, and possessions; and (4) whether the Commission should permit

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[4] 60 FR 17656 (April 7, 1995).

[5] References to the Rule Review comments are cited as: the name of the commenter, RR, commenter number (*e.g.*, NASAA, RR, Comment 43). Commission staff also held two public workshop conferences on the Rule. References to the two Rule Review public workshop transcripts are cited as: name of commenter, Sept95 Tr or March96 Tr, respectively (*e.g.*, D'Imperio, Sept95 Tr, and Ainsley, March96 Tr).

[6] 62 FR 9115 (February 28, 1997).

franchisors to comply with the Franchise Rule's disclosure obligations by posting disclosure documents on the Internet? On the assumption that the Commission would revise the Rule based upon the UFOC Guidelines model, the Commission solicited additional comment on specific disclosure items, including: (1) whether the Commission should modify the litigation disclosures (UFOC Item 3) to require franchisors to disclose law suits filed by franchisors against franchisees; (2) whether the Commission should improve the franchisee statistics disclosures (UFOC Item 20) and if so, how; (3) whether the Commission should modify the Rule to prohibit franchisors from using "gag clauses" that restrict former or existing franchisees from speaking with prospective franchisees or other parties; and (4) whether the Commission should modify the financial performance disclosure requirements (UFOC Item 19) to require franchisors to include specific preambles in their disclosure documents to provide prospective franchisees with more information about financial performance claims.

The ANPR elicited 166 written comments.[7] In addition, Commission staff held six public workshop conferences on the Rule in Washington, D.C. (2 workshops); Chicago, Illinois; New York, New York; Dallas, Texas; and Seattle, Washington. Sixty-seven individuals[8] participated in the public workshops, including franchisees, franchisors, business opportunity sellers, and their representatives, state franchise and business opportunity regulators, and computer consultants. The workshop conferences generated transcripts totaling 1,548 pages.[9] Based upon the comments and the evidence discussed herein, the Commission proposes to amend the Rule in the form set forth *infra* at Section I.

Section B. The Continuing Need for the Franchise Rule

Based upon the record, the Commission believes that the Franchise Rule continues to serve a useful purpose. In response to the ANPR, commenters who address this issue overwhelmingly urge the Commission to retain the Franchise Rule.[10] These commenters,

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[7] The Commission received comments through three means: (1) in writing (108 comments); (2) by E-mail (36 comments); and (3) by telephone (22 comments). Of the 166 comments, 121 were submitted by franchisees or their representatives; 34 were submitted by franchisors or their representatives, and the remainder did not specify any affiliation. A list of commenters and the abbreviations used to identify each is attached as Attachment A.

[8] A list of public workshop participants and the abbreviations used to identify each is attached as Attachment B.

[9] References to the public workshop conferences are cited as: the name of the commenter, date97 Tr at __ (*e.g.,* Simon, 18Sept97 Tr at 146).

[10] *E.g.*, Baer, Comment 25, at 2; Hogan & Hartson, Comment 28, at 2; Kaufmann, Comment 33, at 2-3; SBA Advocacy, Comment 36, at 2-3; Kestenbaum, Comment 40, at 1; IL

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including NASAA,[11] the International Franchise Association ("IFA"),[12] National Consumers League ("NCL"),[13] and prominent franchisors,[14] note that pre-sale disclosure is a cost-effective way to provide material information to prospective franchisees, is necessary to prevent fraud, and enables franchising to flourish. Commenters also observe that pre-sale disclosure helps to reduce economic injury to franchisees by enabling them to understand fully the nature of the franchise relationship and the financial and legal commitments they will be undertaking.[15]

While almost all franchisors responding to the ANPR support the Rule,[16] existing franchisees and their advocates continue to criticize the Rule because it does not address what they believe to be the greatest problem in franchising today: abusive franchise relationships.[17] They believe that the Commission should use its unfairness authority under section 5 of the FTC Act to prohibit, for example, post-term covenants not to compete,[18] encroachment of franchisees'

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[10](...continued)
AG, Comment 77, at 1. At the same time, several commenters urge the Commission to streamline the Rule and to create greater uniformity with state franchise regulations. *E.g.*, Bruce, Comment 3, at 1; Baer, Comment 25, at 2; Kaufmann, Comment 33, at 3; IL AG, Comment 77, at 5; Cendant, Comment 140, at 2.

[11] NASAA, Comment 120, at 1-4.

[12] IFA, Comment 82, at 1-2.

[13] NCL, Comment 35, at 2.

[14] *E.g.*, Cendant, Comment 140, at 1-2. *See also* Better Homes & Gardens Real Estate Service, Re/Max Corporation, and The Prudential Real Estate Affiliates, Inc., (RR Comment 24, at 1); Snap-On, Inc. (RR Comment 27, at 1); Little Caesars (RR Comment 31, at 1); The Southland Corporation (7-Eleven)(RR Comment 47, at 1); Medicap Pharmacies (RR Comment 48, at 1); Forte Hotels (RR Comment 52, at 1).

[15] *E.g.*, Hogan & Hartson, Comment 28, at 2; SBA Advocacy, Comment 36, at 2; Zarco & Pardo, Comment 134, at 1. The record reveals that franchisees may suffer loses of several hundred thousand dollars. *E.g.*, Slimak, 22Aug97 Tr at 26 ($289,000 loss); Lundquist, 22Aug97 Tr at 48 (half a million dollar loss). *See also* NCL, Comment 35, at 2.

[16] *But see* Winslow, Comment 84, at 1.

[17] *E.g.*, Brown, Comment 4, at 2-3; Purvin, Comment 81, at 4.

[18] *E.g.*, Rachide, Comment 32, at 3; AFA, Comment 62, at 3; Slimak, Comment 130, at 1; Vidulich, 22Aug97 Tr at 21.

markets,[19] and restrictions on the sources of products or services.[20] They also urge the Commission to ban franchisors from requiring mandatory arbitration, waiver of jury trials, and choice of venue and choice of law provisions, which they believe often impede a franchisee from bringing suit or favor franchisors in litigation.[21]

Based upon the record and the Commission's law enforcement experience over the last twenty years, the Commission believes that pre-sale disclosure is necessary to protect prospective franchisees from fraudulent and deceptive franchise sales practices. Pre-sale disclosure provides prospective franchisees with material information needed to conduct their own due diligence investigation of the offering, as well as information that prospective franchisees might not otherwise be able to obtain on their own, such as the franchisor's litigation history, failure rates in the franchise system, and audited financial information. Further, complaints from franchisees about various contractual issues are prevalent and strongly suggest that pre-sale disclosure is necessary to ensure that prospective franchisees are better informed about the relationship they will be entering, including issues such as rights to protected territories and product source restrictions.

At the same time, the Commission recognizes that pre-sale disclosure addresses only some of the issues franchisees may face in the course of operating their franchises. From the significant number of complaints filed by existing franchisees, the Commission has no doubt that some franchisees are dissatisfied with their franchise purchase, believe a serious imbalance of power exists between franchisors and franchisees, or otherwise believe that franchise contracts are oppressive. Nonetheless, the record does not support the Commission's ability to broaden the Rule to address substantive franchise relationship issues.

As an initial matter, franchise relationships are matters of contract law that traditionally have been regulated at the state level. Indeed, several states, even those without franchise disclosure laws, have some type of franchise relationship law. In contrast to the states, the Commission traditionally does not regulate or set the terms of private contracts in franchising or in any other economic sector.[22]

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[19] *E.g.*, Brown, Comment 4, at 2; Manuszak, Comment 13, at 1; AFA, Comment 62, at 1; Buckley, Comment 97, at 3; Zarco & Pardo, Comment 134, at 2.

[20] *E.g.*, Colenda, Comment 71, at 1; Slimak, 22Aug97 Tr at 26; Chiodo, 21Nov97 Tr at 293-94.

[21] *E.g.*, Brown, Comment 4, at 3; Bell, Comment 30, at 1; White, Comment 54, at 1; AFA, Comment 62, at 3; Johnson, Comment 67, at 1.

[22] For example, the Commission's Funeral Industry Practices Rule, 16 C.F.R. 453, requires funeral homes to disclose pre-sale the costs of its goods and services, but does not regulate the

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Further, the Commission believes that a widespread misconception exists about the scope of its unfairness jurisdiction. "Unfairness" is a term of art that has a specific legal meaning that has been developed by the Commission over time[23] and adopted by Congress in 1994. Section 5 states that the Commission *does not* have authority to declare an act or practice unfair *unless* it meets three specific criteria: (1) the act or practice causes or is likely to cause substantial injury; (2) that is not outweighed by countervailing benefits to consumers or to competition; and (3) is not reasonably avoidable.[24] Accordingly, before the Commission could consider a rulemaking prescribing the substantive terms of private contracts,[25] the Commission would need evidence not only of substantial harm, but also specific data that would enable the Commission to weigh the purported harm against any countervailing benefits to the public at large or to competition. In addition, the Commission would need evidence showing that franchisees cannot reasonably avoid the alleged harm.

While the Commission finds that franchisees and their advocates suggest economic harm to individual franchisees may result from some franchise practices, they have not shown to date that such harm is substantial and not outweighed by countervailing benefits. Further, in at least some instances, prospective franchisees could also avoid harm by comparison shopping for a franchise system that offers more favorable terms and conditions and by considering alternatives to franchising as a means of business ownership. Thus, the Commission continues to believe that pre-sale disclosure is the best available vehicle, within its statutory authority, to address franchise relationship issues and, as discussed below, proposes to enhance the Rule's disclosures to enable prospective franchisees to investigate the franchise relationship fully before they commit to buying a franchise. This is totally consistent with the Commission's long-held view that free and informed consumer choice is the best regulator of the market.

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[22](...continued)
terms and conditions of private funeral services contracts. Similarly, the Used Motor Vehicle Trade Regulation Rule ("Used Car Rule"), 16 C.F.R. 455, requires used car sellers to disclose pre-sale whether the car comes with a warranty, but does not purport to regulate the terms and conditions of private used car sales.

[23] *See FTC v. Orkin Exterminating Co.*,108 F.T.C. 263 (1986), *aff'd, Orkin Exterminating Co. v. FTC*, 849 F.2d 1354 (11th Cir. 1988), *cert. denied*, 488 U.S. 1041 (1989).

[24] 15 U.S.C. § 45(n) (added by The Federal Trade Commission Act Amendments of 1994, Pub. L. No. 103-312). In amending the FTC Act, Congress also made clear that the Commission may not declare an act or practice unfair based upon public policy concerns alone. *Id.*

[25] In *Orkin*, the seminal case in which the Commission exercised its unfairness jurisdiction in the context of a commercial contract, the Commission neither dictated nor revised the substantive terms of the Orkin contract, but required Orkin to abide by the contractual terms and conditions that Orkin itself freely chose and offered to the public. 849 F.2d at 1363.

Section C. Discussion of Proposed Revisions to the Franchise Rule

1. The Proposed Rule Focuses on the Sale of Franchises

The proposed Rule focuses exclusively on the sale of franchises. The Commission agrees with the overwhelming view of the commenters who address this issue that franchises and business opportunities are distinct business arrangements that require separate disclosure approaches.[26] For example, many of the Rule's pre-sale disclosures, in particular those pertaining to the parties' detailed relationship, do not apply to the sale of most business opportunities, which typically involve fairly simple contracts or purchase agreements. The Rule's detailed disclosure obligations may also create barriers to entry for legitimate business opportunity sellers.[27] Accordingly, the Commission intends to conduct a separate rulemaking proceeding for business opportunity sales.

2. The Proposed Rule is Based Upon the UFOC Guidelines

The proposed Rule is based upon the UFOC Guidelines' disclosure model. Without exception, the commenters who address this issue -- including franchisors and franchisees alike -- urge the Commission to revise the Rule to mirror the UFOC.[28] These commenters emphasize that the UFOC has improved disclosures[29] and is already used by the vast majority of franchisors.[30] Further, uniformity between federal and state franchise disclosure laws will help to reduce compliance costs[31] and will facilitate comparison shopping among franchise systems.[32]

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[26] *E.g.*, Brown, Comment 4; Baer, Comment 25, at 5; Hogan & Hartson, Comment 28; IFA, Comment 82, at 2; NASAA, Comment 120, at 4; Selden, Comment 133, at 2. *But see* NCL, Comment 35.

[27] *See* Muncie, Comment 15, at 2.

[28] *E.g.*, AFA, Comment 62, at 2; IL AG, Comment 77, at 1; IFA, Comment 82, at 1; Bundy, Comment 119, at 1; NASAA, Comment 120, at 2; Cendant, Comment 140, at 2.

[29] *E.g.*, Brown, Comment 4, at 1; Kaufmann, Comment 33, at 3; AFA, Comment 62, at 2; IL AG, Comment 77, at 1; WA Securities, Comment 117, at 1; NASAA, Comment 120, at 2-3.

[30] *E.g.*, Baer, Comment 25, at 2; Hogan & Hartson, Comment 28, at 5-6; Kaufmann, Comment 33, at 3; Kestenbaum, Comment 40, at 1; WA Securities, Comment 117, at 1.

[31] *E.g.*, Brown, Comment 4, at 2; Baer, Comment 25, at 2; AFA, Comment 62, at 2; WA Securities, Comment 117, at 1; NASAA, Comment 120, at 3. Cendant observes that interpretations of the UFOC often vary from state to state and asserts that the Commission's interpretation of the UFOC would bring greater uniformity to the field. Cendant, Comment 140,

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Moreover, as NASAA notes, the UFOC Guidelines were developed with significant input from franchisors, franchisees, and other franchise administrators, and they were subject to public hearings and notice and comment.[33] Indeed, the UFOC Guidelines have been well-received by all interests involved in franchising and have become the national industry standard.[34]

The proposed Rule, however, differs from the UFOC Guidelines in several respects. The Commission has reorganized the UFOC disclosures to conform to the standard *Code of Federal Regulations* format, has edited the UFOC disclosures for clarity, and has streamlined the disclosures where possible. For example, the proposed Rule does not include many of the UFOC Guidelines' detailed instructions, nor its sample answers. In a few instances, the Commission has made substantive changes, enhancing the UFOC disclosures by retaining broader provisions in the current Rule or by adding new disclosures based upon the record and the Commission's law enforcement experience. Each of these changes is discussed in more detail below.

3. Title of the Rule

The Commission proposes to change the title of the Rule to "Disclosure Requirements and Prohibitions Concerning Franchising." This proposed change is necessary to eliminate the current title's reference to business opportunity ventures, which, as discussed above, will be addressed in a separate rulemaking proceeding.

4. Proposed section 436.1: Definitions

The proposed Rule begins with a definitions section that sets forth each definition in alphabetical order. In many instances, the proposed definitions are substantially similar to those already contained in the Rule or in the UFOC Guidelines. In some instances, the Commission proposes to revise a definition for clarity, or to update a definition to embrace long-standing Commission policies. The Commission also proposes to add a few new definitions that are needed to clarify new Rule provisions or instructions (e.g., Internet). At the same time, the Commission proposes to streamline the Rule by eliminating four definitions that no longer serve

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[31](...continued)
at 3.

[32] Kaufmann, Comment 33, at 3.

[33] NASAA, Comment 120, at 2.

[34] *E.g.*, Karp, 19Sept97 Tr at 90.

a useful purpose: (1) "business day;"[35] (2) time for making of disclosures;[36] (3) personal meeting;[37] and (4) cooperative association,[38] as discussed below.

a. Proposed section 436.1(a)("Action"). Proposed section 436.1(a) adopts the UFOC definition of the term "action."[39] It makes clear that disclosures involving litigation include not only civil matters brought before a court, but matters before administrative agencies and arbitrators. This definition is also consistent with the Commission's current interpretation of the term "action."[40]

b. Proposed section 436.1(b)("Affiliate"). In keeping with the Commission's goal of revising the Rule to mirror the UFOC Guidelines, proposed section 436.1(b) adopts the UFOC's definition of the term "affiliate."[41] This definition is greatly streamlined from the current Rule definition, which defines "affiliate" in three parts as follows:

> "The term *affiliated person* means a person . . . (1) Which directly or indirectly controls, is controlled by, or is under common control with, a franchisor; or (2) Which directly or indirectly owns, controls, or holds with power to vote, 10 percent or more of the outstanding voting securities of a franchisor; or (3) Which has, in common with a franchisor, one or more partners, officers, directors, trustees, branch managers, or other persons occupying similar status or performing similar functions.

16 C.F.R. § 436.2(i).

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[35] 16 C.F.R. § 436.2(f).

[36] 16 C.F.R. § 436.2(g).

[37] 16 C.F.R. § 436.2(o).

[38] 16 C.F.R. § 436.2(l).

[39] UFOC Item 3, Definitions, ii.

[40] *See* Final Interpretive Guides, 44 FR at 49966, 49973 (August 24, 1979).

[41] UFOC Item 1, Instructions, v. In several UFOC disclosure items, the term "affiliate" has a more restrictive meaning. In those instances, the definition of "affiliate" is modified, consistent with the UFOC Guidelines.

c. *Proposed section 436.1(c)("Disclose").* Proposed section 436.1(c) is based upon the UFOC's definition of the term "disclose," which incorporates a "plain English" requirement.[42] Currently, there is no comparable Rule definition. The Commission, however, proposes to define the term "plain English" in a separate definition, as discussed below.

d. Proposed section 436.1(d)("Financial Performance Representation"). Proposed section 436.1(d) adds an explicit definition of the term "financial performance representation."[43] The current Rule does not specifically define the term. To the extent that a definition appears, it is cast as a prohibition: It is a violation of section 5 to "make any oral, written, or visual representation to a prospective franchisee which states a specific level of potential sales, income, gross, or net profit for the prospective franchisee, or which states other figures which suggest such a specific level, unless . . ." 16 C.F.R. § 436.1(b).

The Commission believes that the proposed definition of "financial performance representation" combines the best features of both the current Rule and UFOC definitions. Like the current Rule, proposed section 436.1(d) retains the phrase "or which states other figures which suggest such a specific level," which the Commission believes is necessary to ensure that franchisors understand fully that the Rule covers the making of implied financial performance representations. Following the UFOC approach, the definition also specifies that financial performance information may include both historical performance representations and projections and may be in the form of charts, tables, and mathematical calculations. The Commission also proposes to update the definition by clarifying that financial performance representations include those disseminated through the Internet.

e. Proposed section 436.1(e)("Fiscal year"). Proposed section 436.1(e) retains the current definition of the term "fiscal year" set out at 16 C.F.R. § 436.2(m).

f. Proposed section 436.1(f)("Fractional franchise"). Proposed section 436.1(f) slightly modifies the fractional franchise exemption currently found at 16 C.F.R. § 436.2(h). It incorporates the Commission's long-standing policy that the parties must anticipate that the additional sales will not exceed 20 percent of total sales within the first year of operation.[44] The

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[42] UFOC Instruction 150.

[43] The Commission also proposes to use the term "financial performance representation," instead of the widely used "earnings claim." Some franchisors do not use "earnings" as a measure of performance. For example, performance in the hotel industry is typically measured by room occupancy rates.

[44] *See* Final Interpretive Guides, 44 FR at 49968.

definition also makes explicit what previously has been only implied: that the parties must have a reasonable basis to assert the exemption.[45]

g. Proposed section 436.1(g)("Franchise"). Proposed section 436.1(g) modifies the definition of the term "franchise" in three ways. First, the current definition of the term "franchise" was drafted broadly to cover both the sale of franchises and business opportunities. In light of the Commission's proposal to address business opportunity sales in a separate trade regulation rule, the Commission believes the definition of the term "franchise" should now be limited to ensure that it no longer captures ordinary business opportunity sales. To that end, the Commission proposes to revise the second definitional elements: significant control or assistance. Specifically, the Commission proposes to revise the Rule to cover franchisors that exert or have the authority to exert significant "*continuing* control" over the franchisee's method of operation. While franchisors typically exert control throughout the franchise agreement term, business opportunity sellers often do not exert control, or limit their control to the initial stage of a purchaser's business. In a similar vein, the Commission proposes to revise the Rule to cover only franchisors that offer significant assistance "*extending beyond the start of the business operation*," recognizing that in many franchise systems the franchisor's assistance extends beyond the initial phase of the business. For example, the franchisor may offer ongoing advertising, training, and business development plans. In contrast, a business opportunity seller's assistance is often limited to the initial phase of the purchaser's business, such as locating vending machines or providing purchasers with an initial list of accounts.

Second, consistent with its goal of streamlining the Rule wherever possible, the Commission also proposes to eliminate from the current definition of "franchise" the alternative that the franchisee "indirectly or directly [is] required to meet the quality standards prescribed by [the franchisor.]" 16 C.F.R. § 436.2(a)(1)(i)(a)(*2*). The Commission believes that quality standards are simply one form of control that a franchisor may impose on a franchisee. As long as the Rule retains the more inclusive "control" element, the specific "quality standards" element appears to be unnecessary.

Finally, the Commission proposes to modify the definition of the term "franchise" to incorporate three long-standing Commission policies. The revised definition makes clear that: (1) a relationship will be deemed a franchise if it meets the three definitional elements of a franchise, regardless of what it may be called;[46] (2) a business relationship will be deemed a franchise if it is offered or represented as having the characteristics of a franchise, regardless of

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[45] *See* Advisory 97-1 Bus. Franchise Guide (CCH) ¶ 6,481, at 9,681-82 (1997); Advisory 96-2, Bus. Franchise Guide (CCH) ¶ 6,477, at 9,675 (1996).

[46] *See* Final Interpretive Guides, 44 FR at 49966.

any failure on the franchisor's part to perform as promised;[47] and (3) the term "payment" includes payments "by contract or by practical necessity."[48]

h. Proposed section 436.1(h)("Franchise seller"). Proposed section 436.1(h) introduces a new term -- "franchise seller." This definition combines the current terms "franchisor" and "franchise broker" into a single concept. The Commission believes that this approach will streamline the Rule considerably. Currently, whenever the Rule refers to the obligation to furnish disclosure documents, it must specifically refer to both franchisors and franchise brokers. Not only is this reference longer than necessary, it is incomplete because it does not specifically include the franchisor's employees, sales representatives, and agents who also may sell franchises and have an obligation to furnish disclosures. Accordingly, the term "franchise seller" refers to all parties having an obligation to provide disclosure documents. At the same time, the definition adopts long-standing Commission policy that a franchisee seeking to sell its own outlet is not covered by the Rule.[49]

i. Proposed section 436.1(i)("Franchisee"). Proposed section 436.1(i) simplifies the current definition of the term "franchisee." The current Rule defines the term "franchisee" in an awkward and circular fashion: "any person (1) who participates in a franchise relationship as a franchisee, as denoted in paragraph (a) of this section, or (2) to whom an interest in a franchise is sold." 16 C.F.R. § 432.(d). The revised definition deletes unnecessary references to other Rule sections and focuses on the grant of an interest in a franchise, which is the core issue triggering a franchisor's disclosure obligations.

j. Proposed section 436.1(j)("Franchisor"). Similarly, proposed section 436.1(j) streamlines the definition of the term "franchisor." The proposed definition deletes unnecessary references to other Rule sections and focuses on the grant of an interest in a franchise.

k. Proposed section 436.1(k)("Gag Clause"). Proposed section 436.1(k) introduces a new term --"gag clause."[50] As discussed in greater detail below at Section C.8.t., the Commission proposes to amend the Rule to require franchisors to disclose information about gag clauses, namely contractual provisions that prohibit or restrict existing or former franchisees

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[47] SBP, 43 FR at 59699-70.

[48] *See* Final Interpretive Guides, 44 FR at 49967.

[49] *See* Final Interpretative Guides, 44 FR at 49969.

[50] In the ANPR, the Commission used the term "gag orders." During the New York public workshop conference, several panelists were confused by the use of the word "order," noting that it implied a court mandate. *E.g.*, Forseth, 18Sept97 Tr at 40; Zaslav, *id*., at 55. Accordingly, the Commission will use the term "gag clause," to avoid any implication that the Rule will address only court imposed speech restrictions.

from discussing with prospective franchisees their experiences as franchisees. The proposed definition focuses exclusively on a franchisee's ability to discuss his or her personal experience as a franchisee within a franchisor's system. It does not include a confidentiality agreement between a franchisor and a company officer who happens to be a franchisee, and it excludes confidentiality agreements created to protect a franchisor's trade secrets and other proprietary information.

l. Proposed section 436.1(l)("Internet"). Proposed section 436.1(l) is new. It defines the term "Internet" broadly to capture all communications between computers and between computers and television, telephone, facsimile, and similar communications devices. This definition is necessary because, as explained in Section C.10. below, the Commission proposes to amend the Rule to permit franchisors to comply with the Rule electronically, including the use of the World Wide Web and E-mail.[51]

m. Proposed section 436.1(m)("Leased Department"). Proposed section 436.1(m) greatly streamlines the Rule's leased department exemption. Leased departments are one of four express Rule exemptions. Currently, the Rule contains no definition of the term "leased department." Rather, the concept is explained in the exemptions section of the Rule as follows:

> The provisions of this part shall not apply to a franchise . . . [w]here pursuant to a lease, license, or similar agreement, a person offers, sells, or distributes goods, commodities, or services on or about premises occupied by a retailer-grantor primarily for the retailer-grantor's own merchandising activities, which goods, commodities, or services are not purchased from the retailer-grantor or persons whom the lessee is directly or indirectly (a) required to do business with by the retailer-grantor or (b) advised to do business with by the retailer-grantor where such person is affiliated with the retailer-grantor.

16 C.F.R. § 436.2(a)(3)(ii). The Commission believes that the proposed revised definition is shorter, clearer, and easier to understand.

n. Proposed section 436.1(n)("Material"). Proposed section 436.1(n) also streamlines the current definition of "material," which is currently defined as:

> The terms *material, material fact,* and *material change* shall include any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee.

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[51] The proposed definition is modeled, in part, after the definition of "Internet" set forth in the Commission's recently published Request for Comment on the Interpretation of Rules and Guides for Electronic Media, 63 FR 24996-97 and n.1 (May 6, 1998)("Internet Notice").

16 C.F.R. § 436.2(n). The proposed definition eliminates the Rule's current reference to "significant financial impact." The Commission believes that this reference is redundant in that any circumstance impacting upon a person's finances would also necessarily influence his or her decision-making process. Accordingly, the proposed revision is not a substantive change, but simply part of the Commission's effort to streamline the Rule where possible.

o. Proposed section 436.1(o)("Officer"). Proposed section 436.1(o) adds a new definition -- "officer."[52] Although several Rule disclosures pertain to the franchisor's officers -- such as the disclosures for litigation and bankruptcies -- the Rule currently does not specifically define the term "officer." Rather, in the litigation disclosure, the Commission gives examples of an officer, including "the chief executive and chief operating officer, financial, franchise marketing, training, and service officers." 16 C.F.R § 436.1(a)(2). The proposed definition makes clear that franchisors must disclose information about all officers, including *de facto* officers, with significant managerial responsibilities for marketing and/or servicing franchises. The Commission believes that this proposed Rule amendment is necessary to eliminate any doubt that the Rule is to be read broadly, capturing all individuals who function as officers, whether or not they are named in the franchisor's incorporation papers or carry a particular corporate title.[53]

p. Proposed section 436.1(p)("Person"). Proposed section 436.1(p) retains the Rule's current definition of the term "person" set out at 16 C.F.R. § 436.2(b).

q. Proposed section 436.1(q)("Plain English"). Proposed section 436.1(q), a new definition, defines the term "plain English." This definition is necessary because, as discussed below at Section C.9., the Commission proposes to adopt a requirement that franchisors write their disclosure documents in plain English, consistent with the UFOC Guidelines. The proposed definition of "plain English" is modeled after the Securities and Exchange Commission's ("SEC") plain English requirement, set forth in the recently promulgated mutual fund regulations.[54]

r. Proposed section 436.1(r)("Predecessor"). Proposed section 436.1(r) introduces a new term -- "predecessor." Because several of the proposed Rule's disclosures pertain to a

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[52] *See* NASAA UFOC Guidelines Commentary (June 21, 1994) Bus. Franchise Guide (CCH) ¶ 5,800, at 8,466 (Item 4 bankruptcy disclosures).

[53] *See FTC v. P.M.C.S., Inc.*, No. 96-5426 (E.D. N.Y. 1996)(franchisor fails to disclose "silent partner" with prior bankruptcy); *FTC v. Why USA, Inc.*, No. 92-1227-PHX-SMM (D. Ariz. 1992)(franchisor fails to disclose officers and their prior litigation). *See also* Lay, 22Aug97 Tr at 6 (franchisee was not informed that franchisor's director of franchising (who was not a corporate officer) had been declared bankrupt).

[54] Registration Form Used by Open-End Management Investment Companies, SEC Release No. 33-7512, 17 C.F.R. § 274.11A.

franchisor's predecessors, the Commission has incorporated the UFOC's definition of that term.[55] The Commission also proposes to enhance the UFOC definition to make clear that the term "predecessor" includes any person from whom the franchisor has obtained the right to use the trademark or trade secrets associated with the franchise system.

s. Proposed section 436.1(s)("Principal Business Address"). Proposed section 436.1(s) introduces a new term -- "principal business address," modeled after the UFOC's definition of that term.[56] The proposed definition makes clear that a franchisor must use its principal street address, not a post office box or private mail drop. The Commission believes the proposed amendment will reduce fraud in franchise sales by making it easier for prospective franchisees to find and investigate the franchisor and its principals.

t. Proposed section 436.1(t)("Prospective Franchisee"). Proposed section 436.1(t) follows the current Rule's definition of the term "prospective franchisee" set out at 16 C.F.R. § 436.2(e). However, where the definition refers to "franchisor or franchise broker," the Commission has revised the definition to substitute the new term "franchise seller," as discussed above.

u. Proposed section 436.1(u)("Required Payment"). Proposed section 436.1(u) is new. The current Rule does not specifically define the term "required payment." Proposed section 436.1(u) defines that term in accordance with long-standing Commission policy that a payment can be required by contract or by practical necessity.[57]

v. Proposed section 436.1(v)("Sale of a Franchise"). Except for some minor editing, the definition of "franchise sale" is the same as that set out at 16 C.F.R. § 436.2(k).

w. Proposed section 436.1(w)("Signature"). Proposed section 436.1(w) introduces a new term -- "signature." As discussed in Section C.10. below, the Commission proposes to amend the Rule to permit franchisors to use electronic media to furnish disclosure documents under certain conditions, provided prospective franchisees confirm their identity by signing an acknowledgment of receipt. Modeled after the Federal Reserve System's Interim Rule Amending Regulation E, implementing the Electronic Fund Transfer Act ("EFTA"),[58] the proposed definition is flexible, permitting franchisees to confirm their identity by alternative means, such as the use of digital signatures and passwords.

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55 *See* UFOC Item 1.

56 UFOC, Item 1C, Instructions, i.

57 *See* Final Interpretive Guides, 44 FR at 49967.

58 63 FR 14528, 14531 (March 25, 1998).

x. Proposed section 436.1(x)("Trademark"). Proposed section 436.1(x) adopts the Commission's long-standing definition of the term "trademark" to include service marks, logos, and other commercial symbols.[59]

y. Proposed section 436.1(y)("Written"). Proposed section 436.1(y) defines the term "written" to include electronic media, such as computer disk and the Internet. This definition is necessary because, as discussed below at Section C.10., the Commission proposes to amend the Rule to permit franchisors to furnish disclosures electronically. The proposed definition clarifies that electronic media fall within the ambit of a "written" document.[60]

5. Proposed section 436.2: Furnishing and Preparing Disclosure Documents

a. Scope of the Rule. Proposed section 436.2 begins with a new provision that limits the Rule's scope to the sale of franchises in the United States, its possessions, or territories. The overwhelming number of ANPR commenters who address this issue urge the Commission to limit the Rule's application to domestic franchise sales.[61] Only four commenters[62] urge the Commission to enforce the Rule internationally, raising essentially three arguments: (1) it would be inconsistent for a franchisor to subject a foreigner to American law and American courts through contractual choice of venue and choice of law provisions without simultaneously extending the benefit of American law, namely pre-sale disclosure;[63] (2) American citizens who purchase a franchise abroad would not be protected by American law;[64] and (3) the Commission has jurisdiction over foreign franchise sales and should not willingly restrict its own jurisdiction.[65]

The Commission believes that the record adequately supports its tentative finding in the ANPR that mandated pre-sale disclosure in international franchise sales is unnecessary, may be

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[59] *See* Final Interpretive Guides, 44 FR at 49966.

[60] *See* Internet Notice, 63 FR at 24996.

[61] *E.g.*, SBA Advocacy, Comment 36, at 9; Loeb & Loeb, Comment 63, at 2; IFA, Comment 82, at 3-4; Jeffers, Comment 116, at 7; CA Bar, Comment 124, at 2-3; Cendant, Comment 140, at 2 and 4-5.

[62] Brown, Comment 4, at 4-5, and Comments 6, 96, and 103; Stubbings, Comment 21, at 1; Embassy of Argentina, Comment 132, at 1; Selden, Comment 133, at 2-3.

[63] Brown, Comments 6, at 2; Embassy of Argentina, Comment 132, at 1; Selden, Comment 133, at 2.

[64] Selden, Comment 133, at 2. *See also* Stubbings, Comment 21, at 1.

[65] Brown, Comments 4, at 3; 6, at 2; 103, at 15-16.

misleading, and may impede competition. The Commission developed a pre-sale disclosure rule in response to problems occurring in the domestic market.[66] None of the four ANPR commenters noted above offer data or other evidence tending to show that fraud or deception by American companies engaging in international franchises sales is prevalent.

Further, the record strongly supports the view that franchises are sold internationally to sophisticated investors who are generally represented by counsel or who otherwise can protect their own interests. Moreover, there is no evidence in the record that a disclosure document addressing the American market would be beneficial to a prospective foreign investor. Just the opposite appears to be true. Such a document may be irrelevant and potentially misleading when given to a foreign investor (or an American investing in a foreign market) because of vast differences between American and foreign markets, cultures, and legal systems. Risks to the investor would arise primarily from economic conditions and cultural values in those countries, not in the United States. For a disclosure document to be relevant, a franchisor would have to prepare individual disclosure documents tailored to each specific foreign market. Such a requirement, however, would very likely impose extraordinary burdens and costs on franchisors and would impede competition with companies from countries without similar disclosure obligations,[67] despite the lack of evidence in the record of fraud or deception in foreign franchise sales.

Finally, by limiting the application of the Rule to domestic franchise sales, the Commission is not restricting its own jurisdiction. Assuming that the Commission has jurisdiction over foreign franchise sales,[68] it will continue to do so even if the Rule is amended as proposed in the ANPR. Accordingly, in appropriate circumstances, the Commission may address unfair or deceptive franchise sales abroad, consistent with its authority under section 5.[69]

b. Proposed section 436.2(a): Obligation to Furnish Documents. Proposed section 436.2(a) sets forth the Rule's two principal disclosure obligations: It is a violation of section 5 of

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[66] Hogan & Hartson reviewed the Commission's Rule, as well as the UFOC Guidelines, and observed that many of the provisions are limited to disclosures involving the domestic market. For example, UFOC Item 20 refers to the number of franchise sales "in this state." Hogan & Hartson, Comment 28, at 3.

[67] *See* Cendant, Comment 140, at 4.

[68] *See Branch v. FTC*, 141 F.2d 31 (7th Cir. 1944). *But see Nieman v. Dryclean U.S.A. Franchise Company, Inc.*, ___F.3d___ (11th Cir. June 21, 1999).

[69] Even some commenters favoring the ANPR proposal that the Commission limit the Rule's scope acknowledge that the Commission will retain its authority under section 5 to target American companies that may fraudulently sell franchises abroad. *E.g.*, Hogan & Hartson, Comment 28, at 4.

the FTC Act for any franchise seller to fail to furnish prospective franchisees with a copy of the franchisor's disclosure document and the completed franchise agreement within the specific time frames discussed below. Consistent with current Commission policy, this section also provides that the obligation to furnish documents can be satisfied either by the franchisor itself or by another franchise seller.[70] At the same time, it makes clear that all franchise sellers -- including the franchisor's sales representatives and third-party franchise sellers -- can be held individually liable for their failure to furnish prospective franchisees with the required disclosure documents.

c. Proposed section 436.2(a)(1): 14-Day Disclosure Review Period. Proposed section 436.2(a)(1) requires franchisors to furnish prospective franchisees with disclosure documents 14 days before the franchisee signs a binding agreement or pays any fee in connection with the franchise sale. This provision modifies the current Rule provision that requires franchisors to furnish disclosure document at the earlier of the first personal (face-to-face) meeting[71] or at least 10 business days before the franchisee signs a binding agreement or pays a fee.[72]

In the ANPR, the Commission questioned whether the Rule's current requirement that franchisors provide prospective franchisees with a disclosure document at the first personal meeting continues to serve a useful purpose. Recognizing that the term "personal meeting" may be obsolete in light of the growing use of the telephone, facsimile machines, and the Internet as vehicles of commerce, the Commission asked whether the Commission should replace the term "personal meeting" with the term "first substantive discussion."[73]

Several commenters agree that the term "personal meeting" has become irrelevant in an era where even large investments are made by telephone or via the Internet.[74] Many franchisors and their representatives, however, oppose changing the term "personal meeting" to "substantive

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[70] *See* 16 C.F.R. § 436.2(g).

[71] 16 C.F.R. §§ 436.1(a); 436.2(o).

[72] 16 C.F.R. §§ 436.1(a); 436.2(f)-(g).

[73] 62 FR at 9122.

[74] For example, Kennedy Brook observes that franchise sales can occur entirely electronically "where the contact is made over the Web, where E-mail is exchanged, where telephone [calls] are exchanged, where documents are sent out by Federal Express, and where, in fact, there never is a face-to-face meeting." Brooks, 18Sept97 Tr at 160. *See also* NCL, Comment 35, at 4-5; SBA Advocacy, Comment 36, at 9; Kestenbaum, Comment 40, at 2; IL AG, Comment 77, at 3-4; Winslow, Comment 85, at 1.

discussion." They believe that the term "substantive discussion" is ambiguous,[75] and would not reach Internet sales, where presumably no actual discussion takes place.[76] Others fear that franchisors, who may receive countless telephone calls in a day, may have to stop talking with callers, lest they trigger the Rule's disclosure obligations.[77] Several commenters urge the Commission to eliminate the personal meeting trigger altogether and, as an alternative, require franchisors to furnish disclosures a minimum number of days prior to the franchise sale.[78]

The Commission agrees that the personal meeting disclosure trigger has become obsolete in the communications age where prospective sellers now communicate with buyers through a wide array of communications media, including facsimile machine, E-mail, and the Internet. Accordingly, proposed section 436.2(a)(1) streamlines the Rule by eliminating the first personal meeting trigger. As long as the prospective franchisee has a minimum number of days in which to review the franchisor's disclosures, that should suffice to combat deceptive franchise sales. A pre-sale review period can also function as a "cooling-off" period, enabling prospective franchisees to resist high pressure sales techniques. The Commission also proposes to streamline the Rule further by creating a bright line 14-day review period in lieu of the Rule's current "10 business days" provision. The term "10 business days" may be unnecessarily confusing because franchisors must remember to include all federal holidays, some of which are not observed in every state. In addition, in most instances, 10 business days as a practical matter amounts to 14 days.

d. Proposed section 436.2(a)(2): Five-Day Contract Review Period. Proposed section 436.2(a)(2) streamlines the Rule further by requiring franchisors to afford prospective franchisees at least five days to review the completed franchise agreement. This would modify the current Rule provision found at 16 C.F.R. § 436.1(g) that requires franchisors to furnish prospective franchisees with a copy of the completed agreement "at least 5 *business* days prior to the date the agreements are to be executed." The Commission recognizes that five business days usually means seven days. However, the Commission believes that a seven-day contract review requirement might be burdensome for both franchisors and franchisees who often want to sign a

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[75] *E.g.*, Duvall, Comment 19, at 3; Baer, Comment 25, at 6; Loeb & Loeb, Comment 63, at 2; Tifford, Comment 78, at 7-8; IFA, Comment 82, at 4.

[76] Hogan & Hartson, Comment 28, at 9. Kenneth Costello also observes that in the SBP and Final Interpretive Guides the Commission drew a distinction between sales via mail or telephone and face-to-face meetings because the latter could be prone to high pressure sales. He notes that Internet sales require an affirmative action on the part of the prospective franchisee to investigate a franchisor via modem, "a connection that is even more readily broken than a telephone call." Loeb & Loeb, Comment 63, at 2.

[77] Baer, Comment 25, at 6.

[78] Duvall, Comment 19, at 3; Baer, Comment 25, at 6; Tifford, 18Sept97 Tr at 158-59.

franchise agreement quickly in order to cement their deal.[79] The Commission believes that a five-day review period strikes the right balance between affording prospective franchisees time to review the completed contract and accommodating the parties' desire to move the deal forward.

e. Proposed section 436.2(b): Furnishing Disclosures. Proposed section 436.2(b) provides some additional guidance on what constitutes "furnishing" disclosures. It makes clear that franchisors can comply with the Rule's timing provisions by delivering a paper copy, or transmitting an electronic copy of documents, before the required date. It also clarifies that franchisors who wish to mail documents should do so by first class mail and by adding an additional three days in order to ensure that the prospective franchisee receives the documents in the time frame required by the Rule. Otherwise, it is possible that a prospective franchisee may receive a copy of the completed franchise agreement, for example, only a day or two before he or she is scheduled to sign the agreement. The Commission believes that this clarification is essential if the Commission, as proposed above, shortens the timing provision for reviewing completed contacts from "five business days" to a bright line "five days."

f. Proposed section 436.2(c): Form of the Disclosures. Proposed section 436.2(c) provides that it is a violation of section 5 of the FTC Act for a franchisor to fail to include the information and follow the instructions set forth in sections 436.3 - 436.8 of the Rule. It also clarifies the standard of liability for Rule violations. Currently, franchise brokers are jointly liable with the franchisor for the content of a disclosure document. Proposed section 436.2(c) makes clear that franchise sellers other than the franchisor will be liable for the content of a disclosure document only if they knew or should have known of the violation. This is consistent with the standard of individual liability for section 5 violations, as articulated by numerous courts since the Rule was promulgated in the 1970's.[80]

6. Proposed section 436.3: The Cover Page

Proposed section 436.3 requires all franchisors to begin their disclosures with an FTC cover page that informs prospective franchisees that they are receiving important information

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[79] *E.g.*, Wieczorek, 6Nov97 Tr at 25-26.

[80] *See FTC v. Amy Travel Serv.*, 875 F.2d 564, 573 (7th Cir. 1989); *FTC v. Minuteman Press*, Bus. Franchise Guide (CCH) ¶ 11,516 at 31,253 (E.D.N.Y. 1998); *United States v. The Building Inspector of America*, 894 F. Supp. 507, 518-20 (D. Mass. 1995); *FTC v. Jordan Ashley*, Bus. Franchise Guide (CCH) ¶ 70,570 at 72,096 (S.D. Fla. 1994); *FTC v. Kitco of Nevada*, 612 F. Supp. 1282, 1292 (D. Minn. 1985); Under this standard, the Commission has brought numerous actions naming not only owners and corporate officers, but others who are instrumental in the fraud. *E.g., FTC v. FutureNet, Inc.*, No. 98-1113 GHK (AIJx)(C.D. Cal. 1998); *FTC v. Internet Bus. Broad., Inc.*, No. WMN-98-495 (D.Md. 1998); *United States v. Toys Unlimited Int'l, Inc.*, No. 97-08592 Highsmith (S.D. Fla. 1997); *FTC v. Audiotex Connections, Inc.*, No. CV-97-726 (DRH)(VVP)(E.D.N.Y. 1997).

about the franchise offering. The Commission proposes to modify the current cover page requirement, however, to address several suggestions raised in response to the ANPR. For example, a few franchisees and their supporters urge the Commission to require more background information on franchising, its risks, and applicable laws.[81] They also contend that phrases in the current cover page such as "information . . . required by the Federal Trade Commission" and "to protect you" are misleading because they imply greater federal oversight of franchise offerings than actually exists.[82] Several franchisors also urge the Commission to coordinate with the states to produce a single, uniform cover page,[83] and a few question the value of risk factors and whether the Commission could, as a practical matter, require the disclosure of risk factors on a national basis.[84]

The Commission agrees with those commenters who urge the Commission to promote greater uniformity with state disclosure laws. Accordingly, proposed section 436.3 includes the UFOC requirements that the cover page include, for example, the franchisor's name, logo, brief description of the franchised business, total purchase price, and a notice that comparative information is available. The Commission, however, is not inclined to adopt the UFOC's requirement that franchisors disclose specific risk factors on the cover page. First, the Commission notes that the two current UFOC mandated risk factors (choice of venue and law) merely repeat what is already required to be disclosed in the disclosure document itself.[85] Moreover, including these two risk factors in the FTC cover page might incorrectly signal prospective franchisees that these are the most important risk factors for consumers to consider. Second, as a practical matter, the Commission cannot formulate a list of specific risk factors that would be relevant to all franchise systems on a national basis, nor does the Commission have the ability to require risk disclosures on an individual franchise system basis. Nonetheless, the Commission recognizes that state franchise examiners may require franchisors to include various risk factors on the cover page and that such disclosures may serve a useful purpose. In an effort to harmonize federal and state disclosure laws, proposed section 436.3 makes clear that

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[81] Heron, Comment 80, at 1. *See also* G. Gaither, Comment 69, at 1; Dady & Garner, Comment 127, at 3.

[82] *See* Murphy, Comment 2 at 2; Maloney, Comment 38, at 1; Heron, Comment 80, at 1; Kezios, 18Sept97 Tr at 10; Karp, 19Sept97 Tr at 89-90.

[83] *E.g.*, Simon, 18Sept97 Tr. at 9; Kestenbaum, *id.* at 9-10; Cantone, *id.* at 10.

[84] Cendant, Comment 140, at 3; Forseth, 18Sept97 Tr at 11-12; Simon, *id.*, at 12-13, Kestenbaum, *id.*, at 12.

[85] For example, the choice of venue and choice of law disclosures repeat what is already disclosed in the text of Item 17.

franchisors are permitted to include risk factors on the cover page, if they are required to do so under state law.[86]

Proposed section 436.3(b) also updates the current cover page provision to reflect the growing use of the Internet by franchisors. Accordingly, it requires franchisors to include their E-mail address and Internet home page, if applicable, on the cover page. This information should enable a prospective franchisee to communicate more readily with the franchisor. Proposed section 436.3(g)(2) also requires franchisors to include additional statements on the cover page if they wish to comply with the Rule electronically, such as the Internet. These requirements are explained more fully below at Section B.10.

Based upon the comments received, the Commission also proposes to include references to additional resources to enable prospective franchisees to conduct a due diligence investigation of the franchise offering. To that end, proposed section 436.3(g)(3) includes a reference to the Commission's home page[87] where consumers can find resources on franchising, and a reference to the Commission's Guide to Buying a Franchise.[88] In addition, proposed section 436.3(g)(4) adds new language to the cover page pointing out the difference between a disclosure document and a franchise agreement and stresses the need for prospective franchisees to understand their contract.[89]

Finally, proposed section 436.3 eliminates arguably misleading information from the current cover page, namely, the phrases "information . . . required by the Federal Trade Commission" and "to protect you." To the extent that some prospective franchisees may misinterpret the phrase "to protect you" as implying a greater role on the Commission's part, the disadvantages of including such language would appear to outweigh any minimal benefit. Nonetheless, proposed section 436.3 retains the statement that the Commission has not checked the disclosures for accuracy. The Commission believes this statement is essential to warn prospective franchisees not to rely on the franchisor's disclosures at face value.

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[86] *See* Tifford, 18Sept97 Tr at 15-16.

[87] *See* Heron, Comment 80, at 4.

[88] *See* Cordell, 6Nov97 Tr at 156.

[89] One commenter notes that only a minority of prospective franchisees use competent counsel before making an investment decision. He suggests that the Commission essentially require franchisees to seek professional guidance before making an investment decision. Murphy, Comment 2, at 1. The Commission believes such a regulation would be overly intrusive. Nonetheless, in keeping with Mr. Murphy's suggestion, the Commission proposes strengthening the cover page's consumer education message by replacing the current Rule language ("If possible, show. . . "), with the stronger "Show your contract and this disclosure document to an advisor, like a lawyer or an accountant."

7. Proposed section 436.4: Table of Contents

Proposed section 436.4 sets forth a table of contents, which tracks the order of the required disclosures. For the most part, the proposed table of contents follows the text set forth in the UFOC Guidelines. The titles of four disclosure items, however, have been changed. The Commission believes that these changes better capture the essence of the respective disclosure provisions. First, Item 7 has been changed from "Initial Investment" to "Estimated Initial Investment." Second, Item 11 has been changed from "Franchisor's Obligations" to "Franchisor's Assistance, Advertising, Computer Systems, and Training." Third, Item 19 has been changed from "Earnings Claims" to the more inclusive term "Financial Performance Representations." Finally, Item 20 has been changed from "List of Outlets" to "Outlets and Franchisee Information."

8. Proposed section 436.5: The Required Disclosure Items

Proposed section 436.5 sets forth the required disclosure items. For the most part, these proposed disclosures are substantially similar to the disclosure requirements specified in the UFOC Guidelines. The Commission, however, believes it is important to retain a few current Rule disclosure provisions that are broader than the comparable UFOC provisions and to enhance the UFOC disclosures in a few instances based upon the record and the Commission's law enforcement experience.

a. Proposed section 436.5(a): Item 1 (The Franchisor, Its Parent, Predecessors, and Affiliates). Proposed section 436.5(a) is modeled after UFOC Item 1.[90] It requires the disclosure of background information on the franchisor, as well as its parent, predecessors, and affiliates. Proposed section 436.5(a) improves the comparable Rule disclosures currently found at 16 C.F.R. §§ 436.1(a)(1), (a)(3), and (a)(6) in three material respects. First, franchisors must disclose information about their predecessors. This provision is necessary to prevent franchisors from avoiding disclosure obligations by simply assuming a new corporate name.[91] Second, franchisors must disclose any regulations specific to the industry in which the franchise business operates, such as necessary licenses or permits, that may affect the franchisees' ability to conduct business, as well as costs.[92] An explanatory footnote accompanies the Rule's text to help franchisors distinguish between general and industry-specific regulations. Third, franchisors must describe the general competition prospective franchisees are likely to face, which better

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[90] In response to the ANPR, no commenters raised any concerns about UFOC Item 1, upon which proposed section 436.5(a) is based.

[91] *E.g., FTC v. Wolf,* Bus. Franchise Guide (CCH) ¶ 10,401 (S.D. Fla. 1994); *FTC v. Inv. Dev., Inc.,* Bus. Franchise Guide (CCH) ¶ 9,326 (E.D. La 1989).

[92] *E.g., FTC v. Car Checkers of America, Inc.,* Bus. Franchise Guide (CCH) ¶ 10,163 (D.N.J. 1993); *U.S. v. Lifecall Sys.,Inc.,* Bus. Franchise Guide (CCH) ¶ 9,677 (D.N.J. 1990).

ensures that prospective franchisees will understand the likely economic risks in purchasing a franchise. The Commission believes that a disclosure about likely competition is warranted in light of numerous franchisee complaints concerning competition issues.[93]

At the same time, proposed section 436.5(a) retains one feature of the current Rule, namely the disclosure of information about any parent of the franchisor. The Commission believes that information about a franchisor's parent may be highly material to a prospective franchisee. For example, a parent corporation may directly compete with the franchisees by offering franchises under a different trademark or by operating or acquiring a competing franchise system.[94] For this reason, the Commission decided to require the disclosure of information about a parent when it promulgated the Rule originally, even though it recognized that the UFOC Guidelines had no comparable disclosure requirement.[95]

b. Proposed section 436.5(b): Item 2 (Business Experience). Proposed section 436.5(b), another anti-fraud provision, requires a franchisor to disclose the business experience of the company's officers. The Commission has long recognized that the business experience of the franchisor and its officers is material because it provides the "prospective franchisee with an important indication of the franchisor's competence and financial soundness."[96] Proposed section 436.5(b) is substantially similar to UFOC Item 2.[97] However, the Commission proposes to add a provision requiring franchisors to disclose the business experience of any director, trustee, general partner, officer, and subfranchisor of any parent who will have management responsibility relating to the offered franchises. The Commission believes that information about all persons having management responsibility is material to prospective franchisees, regardless of whether the officer is associated with the franchisor or the franchisor's parent.[98]

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[93] *E.g.*, Packer, Comment 10, at 1; Manuszk, Comment 13, at 1; Gray, Comment 22, at 1; Lopez, Comment 123, at 1.

[94] *See* Vidulich, 22Aug97 Tr at 16-17.

[95] SBP, 43 FR at 59639.

[96] SBP, 43 FR at 59640. *See, e.g., FTC v. Car Checkers,* Bus. Franchise Guide (CCH) ¶ 10,163 at 24,043; *FTC v. Nat'l Consulting Group, Inc.,* Bus. Franchise Guide (CCH) ¶ 11,335 (N.D. Ill 1998); *FTC v. Levinger,* No. 94-0925-PHX RCB (D. Ariz. 1994). *Cf. FTC v. Goddard Rarities, Inc.,* No. CV93-4602-JMI (C.D. Cal. 1993).

[97] In response to the ANPR, no commenter raised any concerns about UFOC Item 2, upon which proposed section 436.5(b) is based.

[98] *Cf.* 16 C.F.R. § 436.1(a)(3).

c. Proposed section 436.5(c): Item 3 (Litigation). Proposed section 436.5(c) is modeled after UFOC Item 3.[99] It is one of the most important anti-fraud disclosures, requiring franchisors to disclose certain material litigation involving the franchisor, its parent, predecessors, and officers.[100] Proposed section 436.5(c) improves the comparable Rule disclosures currently found at 16 C.F.R. § 436.1(a)(4) in several material respects. First, it would require franchisors to disclose litigation involving predecessors for the first time. Second, it would require a franchisor to disclose civil actions, other than ordinary routine litigation, that may impact upon the franchisor's financial condition or ability to operate the business.[101] Following the UFOC approach, proposed section 436.5(c) also includes three instructional footnotes, the most important of which advises franchisors on how to disclose settlement agreements that may have confidentiality clauses (footnote 4).[102] The other footnotes clarify when franchisors must disclose

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[99] Only one commenter, Gary Duvall, criticizes the current UFOC Item 3 disclosure, upon which proposed section 436.5(c) is based. Among other things, Mr. Duvall suggests that franchisors should also be able to disclose cases that are resolved in their favor, noting that it might be difficult to distinguish between a dismissal without any liability from a settlement where both parties received some benefit. Duvall, Comment 19, at 1-2. In addition, he opposes the disclosure of confidential settlements, asserting that it "discourages settlement of disputes, and thereby encourages prolonging of litigation and arbitration." Duvall, Comment 83, at 1. The Commission, however, finds that a franchisor can always err on the side of caution and disclose a suit if it is not sure whether or not it is covered by Item 3. In addition, nothing in the Rule would prohibit a franchisor from making any consistent, truthful information known to prospective franchisees outside of the disclosure document. The Commission further believes that confidential settlements provide prospective franchisees with material information needed to assess the franchise offering. Mr. Duvall has submitted no statistics or data to support his bald assertion that the required disclosure of confidential settlements causes harm. Accordingly, the Commission has no basis to conclude that the benefits of such disclosure are outweighed by any costs.

[100] *See, e.g., FTC v. Inv. Dev., Inc.,* No. 89-0642 (E.D. La. 1989); *FTC v. Hayes,* No. 4:96CV06126SNL (E.D. Mo. 1996). *See also* Marks, 19Sept97 Tr at 8.

[101] This disclosure is entirely consistent with long-standing Commission policy that a franchisor's continued financial viability and ability to perform as promised is material to a potential investor. *See, e.g,* SBP, 43 FR at 59650-51, and 59682.

[102] When NASAA revised the UFOC in 1993, it explained that all settlements must be disclosed, regardless of any confidentiality clause they may contain. Recognizing that franchisors may have contractual restrictions on disclosing the existence of confidential settlements, NASAA made the disclosure requirement prospective -- only confidential settlements entered into after April 15, 1993, (the date NASAA approved the revised UFOC Guidelines) must be disclosed. Proposed footnote 4 makes clear that the Commission will

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dismissed civil actions (footnote 2) and the inclusion of summary opinions of counsel (footnote 3).

At the same time, the Commission proposes to enhance UFOC Item 3 by retaining the current Rule provision requiring the disclosure of litigation involving the franchisor's parent. In addition, the Commission would require franchisors to disclose pending franchisor-initiated law suits against franchisees on issues involving the franchise relationship. Currently, the Rule (and UFOC Guidelines) require franchisors to disclose only suits that franchisees have filed against the franchisor. A franchisor must disclose suits it has initiated only if the franchisee were to file a subsequent counterclaim.[103]

Based upon the record, the Commission finds that broader litigation disclosures are warranted to alert prospective franchisees to potential problems in the franchise relationship. In the ANPR, the Commission solicited comment on whether it should amend the Rule's litigation disclosures to require franchisors to disclose franchisor-initiated litigation in all instances.[104] Several commenters favor the ANPR proposal, asserting that franchisor-initiated litigation is material to prospective franchisees because it sheds light on problems in the franchise relationship, as well as the extent to which the franchisor is inclined to use litigation to resolve disputes.[105] Others oppose the ANPR proposal, maintaining that franchisor-initiated litigation is immaterial to prospective franchisees.[106] To the extent a franchisee is aggrieved by a franchisor-initiated suit, the franchisee, in their view, will surely file a counterclaim, which all agree must be disclosed under current law.[107] They also contend that litigation should be limited to suits that imply wrongdoing on the franchisor's part: franchisor-initiated suits simply demonstrate that the franchisor is enforcing its rights under the franchise agreement.[108] They fear that disclosing such litigation would have a negative connotation to prospective franchisees,

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[102](...continued)
follow the NASAA approach.

[103] *See* 16 C.F.R. § 436.1(a)(4)(ii)(B); UFOC, Item 3, A.

[104] 62 FR at 9120-21.

[105] SBA, Comment 36, at 4-5; AFA, Comment 62, at 2; IL AG, Comment 77, at 2; Lagarias, Comment 125, at 3; Selden, Comment 133, Appendix B, at 2; Karp, 19Sept97 Tr at 98.

[106] *E.g.*, Kaufmann, Comment 33, at 4.

[107] *E.g.*, Quizno's, Comment 16, at 1; Kaufmann, Comment 33, at 4; IFA, Comment 82, at 1-2; Cendant, Comment 140, at 3.

[108] *E.g.*, Kestenbaum, Comment 40, at 1; Tifford, Comment 78, at 3.

implying some wrongdoing on the franchisor's part.[109] They also contend that an expanded Item 3 would "bulk up" disclosure documents, thereby increasing compliance costs.[110] One franchisor representative suggests that if the Commission were to require such a disclosure that it consider setting forth a threshold: a franchisor would not have to make the disclosure unless it has sued at least a certain percentage (*i.e.*, 5%) of the franchisees in its system.[111]

After carefully considering the ANPR comments, the Commission proposes to amend the UFOC Item 3 litigation disclosures by requiring franchisors to disclose material information about pending franchisor-initiated litigation involving the franchise relationship. There is no doubt that a franchisor must disclose a franchisor-initiated lawsuit if a franchisee files a counterclaim. In many instances, however, franchisees do not have the financial resources to hire an attorney to initiate a suit or to pursue a counterclaim.[112] Therefore, the disclosure of litigation involving the franchise relationship should not depend upon which party happens to have the resources and the ability to file a law suit.

More important, the Commission is persuaded that franchisor-initiated suits may reveal material information to a prospective franchisee. For example, a franchisor may routinely file suit to collect royalties from franchisees. Such suits may show that franchisees are unwilling to pay royalties, or are having difficulty making their royalty payments. The royalty payments may be too high in light of franchisees' actual earnings, or the franchisees may be unsuccessful and cannot afford to pay the royalty fee. A pattern of such suits is highly material to a prospective franchisee because it is another source of information from which prospective franchisees can assess the quality of the relationship with the franchisor and likelihood of their own success. Moreover, as noted above, the overwhelming number of commenters who responded to the ANPR are current franchisees voicing various complaints about their relationship with the franchisor. These franchisees continue to argue for more substantive regulation of the franchise

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[109] *E.g*, Kaufmann, Comment 33, at 4; Tifford, Comment 78, at 3; Cendant, Comment 140, at 3. On the other hand, Carl Jeffers, a franchise consultant, suggests that the disclosure of franchisor-initiated suits could be viewed as a "positive attribute," showing that the franchisor is willing to enforce its standards and trademark, and is willing to eliminate aggressively continuing violations of its franchise agreement. Jeffers, Comment 116, at 1-2.

[110] *E.g.*, Baer, Comment 25, at 3; Kaufmann, Comment 33, at 4. *See also* Forseth, 18Sept97 Tr at 20.

[111] Baer, Comment 25, at 3.

[112] Peter Lagarias observes that "[f]ranchisors are often able to wield the threat of litigation, especially by threatening to seek attorneys fees, to deter franchisees from suing or maintaining lawsuits against them. Thus, while loss of a single lawsuit is seldom significant to franchisors, loss of a lawsuit against their franchisor is often fatal for franchisees." Lagarias, Comment 125, at 3. *See also* Merret, Comment 126, at 1; Brandt, Comment 137, at 1; Doe, 7Nov97 Tr at 267.

relationship. While the record does not support such a drastic expansion of the Franchise Rule by the Commission, it does support greater disclosure of suits initiated by franchisors against franchisees pertaining to the franchise relationship. Such disclosure no doubt would shed greater light on problems within a franchise system.

At the same time, the Commission shares the commenters' concerns that requiring additional disclosures may increase the costs and burdens of preparing a disclosure document. Therefore, the Commission proposes to limit the disclosure of franchisor-initiated litigation as follows. First, the proposed disclosure is limited to "material" franchisor-initiated law suits.[113] Arguably, an isolated suit against an individual franchisee might not be deemed material given the number of franchisees in the system. Second, the proposed disclosure is limited to suits involving the franchise relationship. Franchisors need not disclose suits they initiated against suppliers, advertisers, or other third parties.[114] Third, the proposed disclosure is limited to pending lawsuits: there is no requirement that franchisor-initiated suits be disclosed for a full 10 years, as franchisors must do for suits alleging, for example, fraud. The Commission believes that restricting the disclosure to pending lawsuits is a good compromise that would likely be sufficient to show a pattern of suits on the franchisor's part without "bulking up" the disclosure document and imposing undue compliance costs.

Finally, the Commission wishes to explore further the suggestion that a franchisor should be required to disclose franchisor-initiated litigation only if the franchisor has sued at least a certain percentage of franchisees in its system. At this time, however, the record is insufficient for the Commission to determine the merits of this suggestion. Accordingly, the Commission seeks comment on whether a franchisor-initiated litigation disclosure should be tied to a threshold and, if so, what threshold would be sufficient.

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[113] *See* Quinzo's, Comment 16, at 1.

[114] Cendant notes that in vicarious liability cases (where a customer sues the franchisor for alleged wrongdoings by the individual franchisee), the franchisor often must sue the franchisee to protect its interests and to obtain indemnification. Cendant believes that such suits are really between the customer and the franchisor and are not indicative of franchise system performance. Cendant, Comment 140, at 3. The Commission agrees. Accordingly, the proposed Item 3 disclosure would require franchisors to disclose only those suits they initiate against franchisees involving the franchise relationship. Most often, this would include suits for failure to pay royalties or to comply with operations standards. It would not extend to all suits filed by the franchisor against the franchisee, such as suits for indemnification for actions outside the franchise contract.

d. Proposed section 436.5(d): Item 4 (Bankruptcy). Proposed section 436.5(d) is substantially similar to UFOC Item 4.[115] It requires franchisors to disclose information about any prior bankruptcies. Proposed section 436.5(d) enhances the comparable Rule disclosures found at 16 C.F.R. § 436.1(a)(5) in two respects: (1) franchisors would disclose bankruptcy information about their predecessors and affiliates; and (2) franchisors would make the disclosures for 10 years, instead of the current seven years. Proposed section 436.5(d) also clarifies that franchisors must disclose foreign proceedings comparable to bankruptcy. Proposed section 436.5(d) differs from the UFOC Guidelines, however, by retaining the Rule's current requirement that franchisors include information about a parent's prior bankruptcy.[116]

e. Proposed section 436.5(e): Item 5 (Initial Franchise Fee). Proposed section 436.5(e) begins a series of three disclosures concerning the total costs involved in purchasing and operating a franchise.[117] Modeled after UFOC Item 5, it requires franchisors to disclose information about the initial franchise fee, including whether such fees are refundable.[118] Proposed section 436.5(e) enhances the comparable Rule disclosures found at 16 C.F.R. § 436.1(a)(7) by enabling franchisors to provide a range of fees, instead of a fixed fee. Arguably, a franchisor who offers a franchise at a price that is not reflected in its disclosure document might violate the Rule because the seller has not provided the prospect with complete and accurate pre-sale disclosure of the price terms. In effect, proposed section 436.5(e) clarifies that franchisors can negotiate with a prospective franchisee over the initial franchise fee, without potentially violating the Rule.

f. Proposed section 436.5(f): Item 6 (Recurring or Occasional fees). Proposed section 436.5(f), the second cost disclosure, is substantially similar to UFOC Item 6.[119] It requires franchisors to disclose recurring fees associated with operating a franchise (*e.g.*, royalties, advertising fees, and transfer fees). This disclosure recognizes that a prospective franchisee's investment is not limited to the initial franchise fee alone. Rather, a franchisee may incur

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[115] In response to the ANPR, no commenter raised any concerns about UFOC Item 4, upon which proposed section 436.5(d) is based.

[116] *See* 16 C.F.R. § 436.1(a)(5).

[117] Pre-sale disclosure of cost information is prevalent in Commission trade regulation rules. *E.g.*, Trade Regulation Rule Pursuant to the Telephone Disclosure and Dispute Act of 1992 ("900 Number Rule"), 16 C.F.R. 308 at § 308.3(b); Telemarketing Sales Rule, 16 C.F.R. 310 at § 310.3; Funeral Industry Practices Rule, 16 C.F.R. 453 at § 453.2.

[118] In response to the ANPR, no commenter raised any concerns about UFOC Item 5, upon which proposed section 436.5(e) is based.

[119] In response to the ANPR, no commenter raised any concerns about UFOC Item 6, upon which proposed section 436.5(f) is based.

considerable costs in the operation of the business that will significantly impact upon his or her ability to continue operations and ultimately be successful.[120]

Consistent with the UFOC Guidelines approach, proposed section 436.5(f) enhances the comparable Rule disclosure provisions found at 16 C.F.R. § 436.1(a)(8) by adding a disclosure about advertising and purchasing cooperatives from which franchisees are required to purchase goods or services. The franchisor must also disclose the voting power of any company-owned outlets in the cooperative and, if company store voting power is controlling, the range of required fees charged by the cooperative must be disclosed. These additional disclosures better enable prospective franchisees to understand their total costs of conducting business.

g. Proposed section 436.5(g): Item 7 (Estimated Initial Investment). Proposed section 436.5(g), the third cost disclosure, requires franchisors to disclose additional expenses necessary to commence business (*e.g.*, rent, equipment, inventory) in an easy-to-read tabular format. It is based upon UFOC Item 7, which addresses fees paid to third parties.[121] Proposed section 436.5(g) enhances the comparable Rule disclosures found at 16 C.F.R. § 436.1(a)(7) by requiring franchisors to disclose "additional funds" required before operations begin and "during the initial phase of the franchise." This information is essentially the same as a working capital disclosure. The UFOC defines the term "initial phase" to mean at least three months or a reasonable period for the industry. Franchisors must also identify the factors, basis, and experience they have considered in determining the level of additional funds. These disclosures assist prospective franchisees to understand not only the costs of entering into the business, but their likely operational costs until they can break even. These enhanced disclosures are entirely consistent with the Rule's general policy of requiring full cost and expense disclosures.

h. Proposed section 436.5(h): Item 8 (Restrictions on Sources of Products and Services). Proposed section 436.5(h) is one of several Rule provisions that require franchisors to state with specificity the legal obligations and restrictions imposed on the franchisee. Modeled after UFOC Item 8, it requires the franchisor to disclose obligatory purchases, restrictions on sources of

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[120] The failure to disclose all material ongoing costs involved in using a product or service is a violation of section 5. *See, e.g., FTC v. Minuteman Press Int'l*, No. C-93-2496-DRH (E.D.N.Y. 1993); *FTC v. SureCheK Sys.* No. 1-97-CV-2015 (JTC)(N.D. Ga. 1997); *In the Matter of Jenny Craig,*1998 FTC Lexis 13 (February 27, 1998*)*; *FTC v. Design Travel,* No. C-97-0833 MHP (N.D. Cal. 1993); *In the Matter of General Motors,* 102 F.T.C. 1741 (1983). Proposed section 436.5(f) is also consistent with many Commission trade regulation rules that require sellers to disclose post-sale costs and conditions that will impact upon the consumer's ultimate cost in using the product or service. *E.g.,* Appliance Labeling Rule, 16 C.F.R. 305 at § 305.11; 900 Number Rule, 16 C.F.R. 308 at § 308.3; Telemarketing Sales Rule, 16 C.F.R. 310 at § 310.3.

[121] In response to the ANPR, no commenter raised any concerns about UFOC Item 7, upon which proposed section 436.5(g) is based.

products and services, the conditions under which the franchisor will approve alternative supplies or products, and the amount of any rebates the franchisor may receive from required suppliers. Proposed section 436.5(h) enhances the current Rule disclosures found at 16 C.F.R. §§ 436.1(a)(9)-(11) by requiring greater disclosure about the circumstances under which the franchisor will authorize substitute goods[122] and whether, by contract or practice, the franchisor provides material benefits to franchisees who use designated or approved suppliers, such as permitting renewals or providing additional outlets. It also requires the disclosure of purchasing or distribution cooperatives and whether the franchisor negotiates purchase arrangements with suppliers for the benefit of franchisees. These additional disclosures enable prospective franchisees to assess better their likely costs and benefits, as well as their independence from the franchisor.

In response to the ANPR, several commenters voice concern about source restrictions that prevent franchisees from obtaining comparable supplies at cheaper rates.[123] For example, one franchisee states that franchisors "put you in an uncompetitive situation with other people in the same business because you are paying higher than fair market value for the price of the goods that you receive from them."[124] These commenters generally do not allege that their franchisors failed to disclose source restrictions, but complain about the abusive nature of such restrictions. Other commenters, however, question the sufficiency of UFOC Item 8, urging the Commission to expand Item 8 to require franchisors to disclose more information about their practices and intentions with respect to the provision of competitive alternative sources of supply,[125] or to require franchisors to include a specific risk factor about sourcing restrictions in their Item 8 disclosure.[126]

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[122] In response to the ANPR, a few franchisees reported that their franchisors failed to approve alternative suppliers or made it difficult for franchisees to find alternative sources of supplies. *E.g.*, Chiodo, 21Nov97 Tr at 308-09; Hockert-Lotz, *id* at 325-327.

[123] *E.g.*, Manuszak, Comment 13, at 1; Weaver, Comment 17, at 1; Mueller, Comment 29, at 2; Gagliati, Comment 72, at 1; Buckley, Comment 97, at 1; Rafizadeh, 7Nov97 Tr at 288-89; Slimak, 22Aug97 Tr at 26. *See also* Kezios, Comment 64, at 2-3..

[124] Brickner, Comment 128. Brickner adds that he also must purchase specific equipment from only one manufacturer and the franchisor is the only supplier. *Id. See also* Buckley, Comment 97 at 3; Myklebust, Comment 101; Chiodo, 21Nov97 Tr at 293-94.

[125] Selden, Comment 133, Appendix B, at 1.

[126] Zarco, Comment 134, at 2. Harold Brown, a franchisee advocate, also urges the Commission to prohibit direct and indirect "kick-backs" from third-party vendors to the franchisor. Brown, Comment 4 at 3. The Commission, however, believes that proposed section 436.5(h)(5), requiring the disclosure of revenue to the franchisor from franchisee purchases, is

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The Commission believes that the ANPR comments clearly support the proposition that full disclosure about source restrictions and purchasing obligations is warranted. Nonetheless, the Commission believes that proposed section 436.5(h) strikes the right balance between pre-sale disclosure and compliance costs and burdens, and is sufficient to warn prospective franchisees about source restrictions, purchase obligations, and approval of alternative suppliers.

i. Proposed section 436.5(i): Item 9 (Franchisee's Obligations). Except for some minor editing, proposed section 436.5(i) is identical to UFOC Item 9.[127] There is no counterpart in the current Rule. Proposed section 436.5(i) requires franchisors to provide an easy-to-understand table that cross references the sections of the franchise agreement and disclosure document that explain the franchisee's legal obligations in greater detail.[128] The Commission finds that this proposed disclosure serves an important consumer protection function, giving prospective franchisees an easy-to-understand roadmap to their franchise agreement and disclosure document, without imposing great compliance costs or burdens on franchisors. In addition, the significant number of comments detailing franchise relationship problems would tend to support the need to provide prospective franchisees with more guidance in understanding and reviewing a franchise agreement.

j. Proposed section 436.5(j): Item 10 (Financing). Proposed section 436.5(j) requires the franchisor to disclose all the material terms and conditions of any financing agreements, including the annual percentage rate, the number of payments, penalties upon default, and any consideration received by the franchisor for referring a prospective franchisee to a lender. For the most part, these disclosures are comparable to the disclosures lenders must make under the Federal Reserve's Regulation M (Consumer Leasing), 12 C.F.R. 213, and Regulation Z (Truth in

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[126](...continued)
sufficient to address this issue.

[127] Only one commenter, Gary Duvall, raises any concern about UFOC Item 9, upon which proposed section 436.5(i) is based. Mr. Duvall suggests that the Commission permit a franchisor to opt out of Item 9 if the franchisor provides prospective franchisees with a detailed table of contents or index to their franchise agreement. Duvall, Comment 19, at 2. In an effort to harmonize federal and state disclosure laws, however, the Commission is inclined to adopt UFOC Item 9 in its entirety.

[128] Proposed section 436.5(i) is consistent with other trade regulation rules where the Commission has recognized that information about legal risks to consumers is material. *E.g.*, 900 Number Rule, 16 C.F.R. 308 at § 308.7 (obligations concerning billing disputes); Negative Option Rule, 16 C.F.R. 425 at § 425.1(a)(1)(ii) (minimum purchase obligations); Door-to-Door Sales Rule, 16 C.F.R. 429 at § 429.1(e) (obligations regarding cancellations); Warranty Disclosures, 16 C.F.R. 701 at § 701.3(a)(5) (obligations to obtain performance).

Lending), 12 C.F.R. 226. Based upon UFOC Item 10,[129] proposed section 436.5(j) enhances the current Rule disclosures found at 16 C.F.R. § 436.1(a)(12) by requiring franchisors to disclose any interest on the financing in terms of an Annual Percentage Rate, consistent with other consumer credit transactions. It also requires more disclosure about what the financing covers, waiver of defenses, and the franchisor's practice or intent to sell or assign the obligation to a third party. Proposed section 436.5(j) also makes clear that the franchisor may provide this information in summary table format, and Appendix A to the proposed Rule offers a sample table.

k. Proposed section 436.5(k): Item 11 (Franchisor's Assistance, Advertising, Computer Systems, and Training). Proposed section 436.5(k) requires franchisors to disclose their obligations to franchisees with respect to pre-opening and ongoing assistance (such as site selection, training, and advertising) in tabular form, with cross references to the corresponding provisions of the franchise contract.[130] It expands the comparable Rule provisions found at 16 C.F.R. §§ 436.1(a)(17)-(18) by requiring franchisors to explain in greater detail their site selection criteria and the nature of their training program. It also requires additional disclosures concerning the extent of advertising assistance and the operation of local, regional, and national advertising co-ops. Proposed section 436.5(k) also addresses major technological changes in franchising since the Rule was promulgated in the late 1970s. Specifically, it requires greater disclosure about the required use of computers and electronic cash registers.[131] The Commission believes that these disclosures are necessary to address frequent franchisee complaints about promised assistance and related obligations. Each of these expanded disclosures sheds greater light on the level of services and assistance promised to prospective franchisees, as well as related franchisee obligations, and therefore are material. The pre-sale disclosure of this information to prospective franchisees is also likely to reduce misunderstandings and conflict during the franchise relationship.

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[129] As with most of the other disclosures, no commenters raised any objections to UFOC Item 10, upon which proposed section 436.5(j) is based.

[130] Misrepresentations about promised support and assistance are among the most common allegations in franchise cases and continue to be a source of numerous franchisee complaints. *E.g., FTC v. Nat'l Consulting Group, Inc.,* No. 98 C 0144 (N.D. Ill 1998); *FTC v. Hayes,* No. 4:96CV061126 SNL (E.D. Mo. 1996); *FTC v. Int'l Computer Concepts, Inc.,* No. 1:94CV1678 (N.D. Ohio 1994); *United States v. Megatrend Telecomm., Inc.,* No. 3:93 CV 22220 AVC (D. Ct. 1993); *FTC v. Intellipay, Inc.,* Bus. Franchise Guide (CCH) ¶ 10,061 (S.D. Tx. 1992); *FTC v. Blanc,* Bus. Franchise Guide (CCH) ¶ 10,032 (N.D. Ga. 1992). *See also* Lundquist 22Aug97 Tr at 45; Gray, Comment 22, at 1; Dady & Garner, Comment 127, at 4; Mousley, 29July97 Tr at 4-7.

[131] In response to the ANPR, a few commenters voiced concerns about maintenance obligations regarding computer systems and related equipment. *E.g.,* Fetzer, 19Sept97 Tr at 42; Rafizadeh, 7Nov97 Tr at 292. *See also* NCA-7 Eleven Franchisees, Comment 113, at 2.

Two commenters, however, question the sufficiency of UFOC Item 11, upon which proposed section 436.5(k) is based. One franchisee advocate contends that the UFOC Item 11's short-hand references to the franchise contract "offend[s] the basic purpose of the disclosure statement, namely, to provide the prospective franchisee with a reliably complete description of what is being purchased."[132] He urges the Commission to require a franchisor to provide prospects with a more in-depth analysis of each of the franchisor's obligations. A franchisor representative raises a concern about the disclosures concerning computer systems. UFOC Item 11, and by extension proposed section 436.5(k), require franchisors to disclose information about the nature of their computer systems and any assistance available to franchisees concerning such systems. This commenter does not disagree with the need for the disclosure, but notes that many start-up franchisors are "not certain which computer system or software they expect to have the franchisees use. Provision should be made for these new franchisors."[133]

In light of the overwhelming number of comments urging the Commission to adopt the UFOC format, the Commission finds no compelling justification to expand Item 11, as suggested above. Requiring franchisors to repeat in the disclosure document what they already disclose in their contract would appear to impose costs on franchisors without any clear benefit to prospective franchisees. Multiple disclosure might greatly increase the size of a disclosure document, making it more daunting to read. The Commission, however, is concerned that the UFOC Item 11 disclosures concerning computer systems may not provide adequate guidance to start-up franchisors. Specifically, a start-up franchisor may require franchisees to use computer systems in the future, but may not have the specific computer requirements available at the time of the franchise sale. Based upon the record, the Commission cannot assess the extent to which proposed section 436.5(k) may impose undue costs or burdens on, or otherwise disadvantage, start-up franchise systems. Accordingly, the Commission solicits additional comment on this issue.

l. Proposed section 436.5(l): Item 12 (Territory). Proposed section 436.5(l) addresses exclusive territories, as well as competition from franchisors selling similar goods or services under the same or a different trade name. The Commission believes this provision is one of the most important disclosure items, preventing fraud and misleading statements concerning protected territories and competition. Indeed, the Commission has brought a number of law enforcement actions against false or misleading exclusive territory representations.[134] Proposed

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[132] Brown, Comment 4, at 5.

[133] Kestenbaum, Comment 40, at 2.

[134] *E.g., FTC v. Int'l Computer Concepts, Inc.,* No. 1:94CV1678 (N.D. Ohio 1994); *FTC v. O'Rourke,* No. 93-6511 (S.D. Fla. 1993); *FTC v. Nat'l Bus.Consultants, Inc.,* Bus. Franchise Guide (CCH) ¶ 9,365 (E.D. La. 1989); *FTC v. American Safe Mktg., Inc.,* Bus. Franchise Guide (CCH) ¶ 9,350 (N.D. Ga. 1989); *FTC v. American Legal Distrib., Inc.,* Bus. Franchise Guide (continued...)

section 436.5(l) enhances the current Rule's disclosures found at 16 C.F.R. §§ 436.1(a)(3)-(13) in several respects, including requiring franchisors to disclose the conditions, if any, under which they will approve the relocation of the franchisee's business and the franchisee's establishment of additional outlets. Franchisors must also disclose any present plans to operate a competing franchise system offering similar goods or services or to sell through alternative channels of distribution.

Unlike most disclosure items -- which generated little comment in response to the ANPR -- UFOC Item 12 generated a significant number of comments. In particular, franchisees and their advocates complain about "encroachment," where a franchisor essentially competes with its franchisees by establishing company-owned or new franchised-outlets in the same market, or sells the same goods as the franchisee through alternative channels of distribution.[135] These commenters contend that encroachment has a devastating effect upon an individual franchisee who does not have a contractual right to an exclusive territory,[136] and they urge the Commission to ban encroachment as an abusive and unfair practice. Other commenters urge the Commission at the very least to expand the disclosures about territories to include more information about the franchisor's past practices and specific expansion plans.[137] Finally, several franchisees suggest that the Commission should strengthen the UFOC's "encroachment" risk factor. For example, one commenter suggests that franchisors should be required to state: "The company reserves the right to increase the number of franchised or company-owned units in an area. In the past, we have been known to put another outlet in close proximity to an existing unit. This action generally has a negative impact on the gross and/or net sales of the pre-existing unit."[138]

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[134](...continued)
(CCH) ¶ 9,090 (N.D. Ga. 1988); *United States v. C.D. Control Tech., Inc.*, Bus. Franchise Guide (CCH) ¶ 9,851 (E.D.N.Y. 1985).

[135] *E.g.*, Brown, Comment 4, at 2; Manuszak, Comment 13, at 1; AFA, Comment 62, at 1; Orzano, Comment 73, at 1; Buckley, Comment 97, at 3; Marks, Comment 107, at 2; Zarco & Pardo, Comment 134, at 2.

[136] *E.g.*, Parker, Comment 10, at 1; L. Gaither, Comment 68, at 1; Vidulich, 22Aug97 Tr at 17; Cristiano, 19Sept97 Tr. at 50; Bundy, 6Nov97 Tr at 135.

[137] For example, Andrew Selden suggests that "Item 12 should be elaborated to require full disclosure of past practice, current intention or future possibility of franchisor-sponsored competitive activities that have the prospect of impacting the franchisee's business." Selden, Comment 133, Appendix B, at 1. *See also*, Dady & Garner, Comment 127, at 4.

[138] Zarco & Pardo, Comment 134, at 2. *See also* G. Gaither, Comment 69, at 1; Orzano, Comment 73, at 1; Dady & Garner, Comment 127, at 3; Cordell, 6Nov97 Tr at 136; Kezios, 6Nov97 Tr at 142.

The Commission believes that proposed section 436.5(l) strikes the appropriate balance, ensuring that prospective franchisees will receive material information about the extent to which they will receive a protected territory and/or are likely to face competition from the franchisor. Disclosure about a franchisor's past practices and future policies, however, appears to be unwarranted. A franchisor's past policies and practices regarding territories and means of distribution are arguably irrelevant because they do not necessarily shed any light on the franchisor's practices that will govern a particular franchise relationship.[139] In the same vein, a franchisor's expansion policies in one location may be irrelevant to a prospective franchisee who intends to operate his or her outlet in another. Moreover, prospective franchisees may be able to discover past practices on their own by speaking with current and former franchisees.

The Commission also believes it is unreasonable to require franchisors to disclose hypothetical possibilities about future expansion. Indeed, by not granting an exclusive territory, the franchisor has effectively reserved to itself the unrestricted right to expand the number of outlets or to sell its products or services via alternative channels of distribution. For that reason, proposed section 436.5(l) provides that franchisors not offering exclusive territories must state: "You will not receive an exclusive territory. [Franchisor] may establish other franchised or company owned outlets that may compete with your location." Although the Commission generally disfavors the use of risk factors that merely repeat what is expressly or impliedly stated in the franchise agreement, the Commission agrees that the disclosure of this specific risk factor is warranted in light of the considerable number of franchisee complaints regarding encroachment. Armed with such information, prospective franchisees can shop for a competing franchise system that does offer protected territories, if they so choose.

m. Proposed section 436.5(m): Item 13 (Trademarks). Proposed section 436.5(m) is intended to be identical to UFOC Item 13. It requires franchisors to disclose information about the principal trademarks that will be licensed to the franchisee for use in operating the outlet.[140] This is an anti-fraud provision, ensuring that franchisors do not misrepresent the value of the trademark underlying the franchise system.

The current Rule provision addressing trademarks, section 436.1(a)(iii), merely requires the franchisor to identify its trademarks. Following UFOC Item 13, proposed section 436.5(m) enhances the current Rule requirements by requiring more detailed disclosures, including

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[139] The Commission believes that the issue of encroachment is essentially a contractual matter. Absent an express grant of a protected territory, a franchisor is generally free to establish as many outlets (company-owned or franchised) in any particular market as it wishes. A few state courts (or federal courts applying state law), however, have held that encroachment violates state implied covenants of good faith and fair dealing. *See, e.g., In re Vylene Enter., Inc.*, 90 F.3d. 1472 (9th Cir. 1996).

[140] In response to the ANPR, no commenter raised any concerns about UFOC Item 13, upon which proposed section 436.5(m) is based.

whether the trademark is registered with the U.S. Patent & Trademark Office,[141] and the existence of any pending litigation, settlements, agreements, or superior rights that may limit the franchisee's use of the trademark. Proposed section 436.5(m) also explains the franchisor's contractual obligations to protect the franchisee's right to use the mark against claims of infringement or unfair competition. These additional disclosures are entirely consistent with the Commission's long-standing policy of requiring the disclosure of material information about the costs and benefits of entering into the franchise relationship.

n. Proposed section 436.5(n): Item 14 (Patents, Copyrights, Proprietary Information). Proposed section 436.5(n) is intended to be identical to UFOC Item 14.[142] It is another anti-fraud provision, ensuring that franchisors do not misrepresent the nature of their intellectual property, such as secret recipes or manufacturing processes, the existence of which often makes the purchase of a franchise an attractive option, especially to consumers without prior business experience. Like trademark limitations, restrictions on the use of the franchisor's intellectual property are material because they not only can seriously diminish the value of the franchise, but could undermine the franchisee's ability to operate the business. No comparable provision is found in the current Rule. In keeping with the goal of reducing inconsistencies between federal and state disclosure law, the Commission believes that adopting UFOC Item 14 is warranted.[143]

o. Proposed section 436.5(o): Item 15 (Obligation to Participate in the Actual Operation of the Franchise Business). Proposed section 436.5(o) is intended to be identical to UFOC Item 15.[144] It requires franchisors to disclose whether franchisees must participate personally in the direct operation of the franchise.[145] Proposed section 436.5(o) enhances the

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[141] If the mark is not registered, the franchisor must provide the following warning: "By not having a Principal Register federal registration for (name or description of symbol), (Name of Franchisor) does not have certain presumptive legal rights granted by a registration."

[142] In response to the ANPR, no commenter raised any concerns about UFOC Item 14, upon which proposed section 436.5(n) is based.

[143] Proposed section 436.5(n) is substantially similar to other required disclosures. It complements Item 13, which requires the disclosure of information about the franchisor's trademark, and it parallels Item 3, which requires the disclosure of certain litigation.

[144] In response to the ANPR, no commenter raised any concerns about UFOC Item 15, upon which proposed section 436.5(o) is based.

[145] This requirement is consistent with the Commission's long-standing view that prospective franchisees should be able to assess their legal obligations under the franchise agreement, as well as the degree of independence they will be able to exercise in operating their business. SBP, 43 FR at 59662-63. Personal participation requirements might also result in

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current Rule disclosures found at 16 C.F.R. § 436.1(a)(14), however, in several respects. It requires franchisors to disclose not only obligations under the franchise agreement, but obligations to participate directly arising from other agreements or as a matter of practice. Franchisors must also state if direct participation is recommended. Proposed section 436.5(o) also requires franchisors to disclose any limitations on whom the franchisee can hire as a supervisor and any restrictions that the franchisee must place on its manager. If the franchise is a business entity, the franchisor must also disclose the amount of equity interest that the supervisor must have in the franchise. Armed with such disclosures, prospective franchisees will have a much better understanding of the personal commitment required to operate the franchise.

p. Proposed section 436.5(p): Item 16 (Sales Restrictions). Proposed section 436.5(p) is intended to be identical to UFOC Item 16.[146] Like other Rule provisions governing a franchisee's method of operation, it requires a franchisor to disclose any restrictions limiting customers to whom the franchisee is permitted to sell, or the goods or services that the franchisee may offer for sale.[147] Proposed section 436.5(p) enhances the current Rule disclosures found at 16 C.F.R. § 436.1(a)(13) by also requiring the franchisor to disclose whether the franchisor has the right to change the types of authorized goods and services and whether there are limits on the franchisor's right to make such changes. These disclosures will better enable a prospective franchisee to understand the scope of the franchisor's contractual rights regarding product sales.

q. Proposed section 436.5(q): Item 17 (Renewal, Termination, Transfer, and Dispute Resolution). Proposed section 436.5(q) is intended to be identical to UFOC Item 17. It requires franchisors to summarize in tabular form 23 enumerated terms and conditions of a typical franchise relationship, such as the duration of the franchise agreement, rights and obligations upon termination, post-term covenants not to compete, and assignment and transfer rights.[148]

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[145](...continued)
economic injury to franchisees who, under their franchise agreement, are restricted from engaging in other businesses or who have signed covenants not to compete in the same business. *Id.*

[146] In response to the ANPR, no commenters raised any concerns about UFOC Item 16, upon which proposed section 436.5(p) is based.

[147] Sales restrictions can cause serious economic injury to franchisees by limiting the scope of the franchisee's market and ultimately the franchisee's profitability. SBP, 43 FR at 59661. Comparable disclosures about the terms, conditions, and restrictions on the use of goods and services are found in many Commission rules. *E.g.*, Telemarketing Sales Rule, 16 C.F.R. 310 at § 310.3; Negative Option Rule, 16 C.F.R. 425 at § 425.1(a)(1)(ii); Disclosure of Warranty Terms and Conditions, 16 C.F.R. 701 at § 701.3(a)(8).

[148] The Commission has recognized that the terms and conditions governing the franchise
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Proposed section 436.5(q) enhances the current Rule disclosures found at 16 C.F.R. § 436.1(a)(15) by requiring disclosures about arbitration or mediation of disputes, as well as forum-selection and choice of law provisions. At the same time, it greatly streamlines the Rule's disclosures. The Rule currently requires franchisors to detail the rights and obligations already spelled out in the franchise agreement. Proposed section 436.5(q), in contrast, requires franchisors to cross reference the applicable contractual provisions in an easy-to-read table with only a brief summary of each provision. This streamlined approach reduces compliance burdens, while providing prospective franchisees with a detailed road map to the contract, where they can read the various provisions in greater detail.

In response to the ANPR, a few commenters offer specific suggestions about UFOC Item 17, upon which proposed section 436.5(q) is based. One commenter questions whether the Item 17 disclosure is necessary in the first instance, suggesting that a franchisor be permitted to opt out of Item 17, if it provides a detailed table of contents or index to its franchise agreement.[149] In addition, several franchisees and their representatives state that the term "renewal" in Item 17 is misleading. They maintain that the word "renew" implies that the franchisee is able to continue to operate the franchise under substantially similar terms and conditions as under the original franchise agreement. They assert, however, that in reality franchisees who wish to continue operating the franchise upon expiration must often sign radically new contracts that impose substantially different terms and conditions, such as higher royalty payments or the elimination of an exclusive territory. Further, they assert that, in many instances, franchisees have no choice but to sign even the most abusive, one-sided contracts because the franchisee has a substantial economic investment in the franchise and simply cannot walk away from it without incurring a significant economic loss.[150] Franchisees also note that if they do walk away from the franchise,

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[148](...continued)
relationship "may well be the most important provisions in a franchise agreement, since they limit what the franchisee may do with his capital asset." Given the length and complexity of the typical franchise agreement, such terms and conditions are often overlooked or not fully appreciated. The Commission has also recognized that there is often an informational imbalance between franchisors and franchisees about the relationship. "This information imbalance makes the clear and concise disclosure [about franchise relationship issues] essential, if a prospective franchisee is to make an informed business judgment." SBP, 43 FR at 59664.

[149] Duvall, Comment 19, at 2.

[150] *E.g.*, Bores, Comment 9, at 1; Rachide, Comment 32, at 1; Chabot, Comment 37, at 1; Rich, Comment 65, at 1; Orzano, Comment 73, at 1; Geiderman, Comment 131, at 1; Vidulich, 22Aug97 Tr at 19-20; D'Alessandro, 22Aug 97 Tr at 41; Chiodo, 21Nov97 Tr at 303-04.

they are often bound by covenants not to compete that restrict their ability to operate a similar business for a number of years.[151]

As noted previously, the overwhelming number of ANPR comments were submitted by franchisees who voice various franchise relationship concerns.[152] The stream of franchisee complaints about relationship issues demonstrates that there is a continuing need for complete and clear disclosure about the basic contractual terms and conditions that will govern the franchise relationship. In an effort to harmonize federal and state disclosure laws, the Commission is inclined to adopt UFOC Item 17 as set forth in the UFOC Guidelines. Nonetheless, the Commission wishes to explore further whether the use of the term "renewal" is misleading. On the one hand, "renewal" appears to be a term of art that is well understood in franchising to mean that the parties enter into a new contract. Indeed, UFOC Item 17 specifically distinguishes between renewals and extensions. Although not defined in the Rule, the term "extension" implies that a franchisee can continue to operate under the same terms and conditions for an additional period. In contrast, it would appear that a "renewal" means that the franchisee may continue in operation, but under modified conditions. Given the number of comments on this issue, however, the Commission wishes to explore further whether the term "renewal" is misleading and possible alternatives that would be more useful.

r. Proposed section 436.5(r): Item 18 (Public Figures). Proposed section 436.5(r) is intended to be identical to UFOC Item 18.[153] It requires franchisors to disclose the involvement of a public figure in the franchise system, including any management responsibilities, the total investment made in the franchise system, and any compensation received. A comparable disclosure provision is currently found at 16 C.F.R. § 436.1(a)(19). This information helps

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[151] For example, the AFA states:

> "Renewal" is a misnomer. "Re-license," "rewrite" or even "re-franchise" is a more accurate description of what actually happens at the end of the initial contract term. Most franchisees find that when it is time to "renew," they are not "renewing" their existing franchise agreement, but are entering into a wholly new franchise agreement, often with materially different financial and operational terms. They are presented these "renewal" contracts on a "take it or leave it" basis and are under enormous coercion pressures to sign -- especially if the old agreement contains a post-termination covenant not to compete. This is truly "holding a gun to the head" of the "renewing" franchisee.

AFA, Comment 62, at 2.

[152] *See supra* at Section B.

[153] In response to the ANPR, no commenter raised any concerns about UFOC Item 18, upon which proposed section 436.5(r) is based.

prospective franchisees understand the extent of any financial and managerial commitments from the public figure, as well as any obligations to the public figure. Prospective franchisees can then decide for themselves whether an association with a public figure is valuable to them.[154]

s. Proposed section 436.5(s): Item 19 (Financial Performance Representations).

Background. Proposed section 436.5(s), perhaps the most important anti-fraud provision, addresses financial performance representations. In the original rulemaking record developed in the 1970s, the Commission found "that franchises have been marketed through . . . unsubstantiated claims regarding potential sales, income, [and] gross or net profit of franchises."[155] The Commission's law enforcement experience shows that the making of false or unsubstantiated earnings representations continues to be prevalent. Indeed, the making of false or unsubstantiated earnings representations is the most frequent count alleged in Commission Franchise Rule cases. Of the more than 150 Rule cases filed to date, all but three allege false or unsubstantiated earnings claims.[156]

Although financial performance representations are highly material to prospective franchisees, the Commission stated in the ANPR that it was inclined not to mandate earnings disclosures.[157] After reviewing the Rule Review comments, the Commission acknowledged that financial performance information is material to prospective franchisees, but rejected mandating such disclosures in favor of a free market approach. The Commission noted that approximately 20 percent of franchisors choose to make earnings disclosures and that prospects, in theory, can find franchise systems that voluntarily disclose earnings information. Moreover, the Commission observed that prospective franchisees can obtain earnings information from a variety of sources. "For example, typical expenses, such as labor and rent, may be available from industry trade associations and industry trade press." 62 FR 9118. Prospective franchisees are also free to discuss earnings and other performance issues with former and current franchisees. Perhaps most important, the Commission noted that the record does not provide a sufficient basis for the Commission to formulate an earnings disclosure that would both be useful to and not mislead prospective franchisees. The Commission also noted that mandating earnings disclosures might impose burdens and costs on existing franchisees (who would have to release

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[154] *See* SBP, 43 FR at 59677-78.

[155] Final Interpretive Guides, 43 FR at 59628.

[156] *E.g., FTC v. GreenHorse Communications, Inc.,* No. 98-CV-245-M (D. N.H. 1998); *FTC v. Nat'l Consulting Group, Inc.,* No. 98-C 0144 (N.D. Ill. 1988); *FTC v. Hart Mktg. Enter.,Ltd.,* No. 98-222-CIV-T-23E (M.D. Fla. 1988); *FTC v. Shelton,* No. CV-N-97-00712-ECR (RAM)(D. Nev. 1997); *FTC v. Hayes,* No. 4:96CV06126 SNL (E.D. Mo. 1997); *FTC v. Tower Cleaning Sys., Inc.,* No. 96 58 44 (M.D. Pa. 1996).

[157] 62 FR at 9118.

their earnings information to their franchisor) without any record support showing that such increased burdens and costs are outweighed by benefits to prospective franchisees.[158]

While rejecting mandated financial performance disclosures, the ANPR explored whether the Commission should nonetheless revise the Rule's performance disclosure requirements in two respects. First, the Commission observed that some franchisors actually misrepresent that the Commission or the Franchise Rule prohibits franchisors from making performance information available.[159] Second, the Commission questioned whether prospective franchisees should be cautioned not to rely on unsubstantiated earnings representations.[160] Accordingly, the Commission solicited comment on whether the Rule should be modified to require all franchisors to provide specified preambles to their Item 19 disclosure that would explain financial performance representations in greater detail.[161] The prescribed preamble would make it clear that franchisors can make earnings disclosures if they have a reasonable basis to do so. At the same time, it would discourage prospects from relying on unauthorized earnings information.[162]

In general, no new arguments were raised in response to the ANPR either supporting or opposing mandatory earnings disclosures. Franchisees and their allies continue to argue that earnings information is material, that mandating earnings disclosures will curb deceptive or false

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158 *Id.*

159 *Id.*

160 *Id.*

161 The ANPR proposed that all franchisors state the following in their Item 19 disclosure:

> The FTC's Franchise Rule permits a franchisor to provide you with information about the actual or potential sales, income, or profits of its outlets, provided that there is a reasonable basis for such information and the franchisor offers to provide you with written substantiation. You should not rely on any information on sales, income, or profits provided by a franchisor or its salespersons if written substantiation is not offered.

Franchisors who do not make earnings disclosures would add the following additional statement:

> This franchisor does not make any representations about sales, income, or profits. We also do not authorize our salespersons to make any such representations either orally or in writing.

Id. at 9121-22.

162 *Id.* at 9119.

earnings claims already being made, and that it is a material omission for franchisors to fail to disclose earnings information they possess.[163] They also contend that prospects need historical earnings information in order to conduct a due diligence investigation of the franchise offering.[164] On the other hand, franchisors and their allies continue to oppose mandatory earnings disclosures, maintaining that earnings information obtained from franchisees is often unavailable or unreliable, that mandating the disclosure of earnings information will increase litigation, and that prospects can often obtain earnings information directly from current and former franchisees.[165] In addition, a few commenters urge the Commission to coordinate its policy with NASAA to promote uniformity between federal and state disclosure laws.[166] One franchisor suggests that the FTC prohibit states from mandating earnings disclosures by preempting the field.[167]

At the same time, several commenters support the ANPR proposed preambles as an alternative to mandating earnings disclosures, noting that this approach would rely on market pressures, not government mandates, to encourage franchisors to disclose earnings information voluntarily. For example, one commenter states:

> We believe that these required disclosures not only would correct misrepresentations by franchisors that the Rule prevents them from making earnings claims, but also would bring more market pressure to bear on franchisors to make reliable earnings claims. Such market pressures may result in a substantial increase in the amount of financial information disclosed to

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[163] *E.g.*, Brown, Comment 4, at 4; SBA Advocacy, Comment 36, at 8; AFA, Comment 62 at 4; Purvin, Comment 79, at 2; Lagarias, Comment 125, at 1-2; Dady & Garner, Comment 127, at 1-2; and Selden, Comment 133, at 2 and Appendix C; Lundquist, 22Aug97 Tr at 46-47.

[164] *E.g.*, Karp, 19Sept97 Tr at 100-01. Quoting several business texts, Mr. Karp asserts that historical earnings information is critical to any evaluation of a business. For example, he cites Internal Revenue Service Ruling 59-60, Item D, which provides that: "detailed profit and loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years." Mr. Karp believes that the failure of franchisors to disclose historical earnings information deprives prospects of material information that is essential in evaluating the franchise offering.

[165] *See, e.g.*, Duvall, Comment 19, at 2; Hogan & Hartson, Comment 28, at 7; Kaufmann, Comment 33, at 7; Tifford, Comment 78, at 5; IFA, Comment 82, at 3; Jeffers, Comment 116, at 5.

[166] Tifford, Comment 78, at 6; AFA, Comment 62, at 4; IL AG, Comment 77, at 2; IFA, Comment 82, at 3.

[167] Cendant, Comment 140, at 2.

> franchisees without the costs and other burdens attendant to a government mandate.

Hogan & Hartson, Comment 28, at 8.[168]

A few commenters, however, offer specific suggestions to improve the proposed preambles. For example, some commenters voice concern that phrases such as "do not rely on" unauthorized earnings information may be misinterpreted as a disclaimer of liability where salespeople routinely make false or unauthorized earnings claims.[169] Another commenter voices concern that the first preamble proposed in the ANPR could be misinterpreted as enabling franchisors to provide earnings information outside of the disclosure document, as long as the franchisor followed the Rule's requirements.[170] Several commenters also offer substitute language. For example, one commenter notes that some industries -- such as the hotel industry -- do not use sales, income, or profits as measures of performance.[171] He suggests that the preamble include the more inclusive term "financial performance" to capture those industries. Another commenter recommends that the term "outlets" be revised to make it clear that a financial performance claim can be based on either company-owned or franchised outlets.[172] A few commenters also suggest that the Commission add a provision stating that prospective franchisees should report any unauthorized financial performance claims to the franchisor and/or to the Federal Trade Commission and to state authorities.[173] Finally, NASAA suggests that the Commission require franchisors who choose not to make earnings disclosures to make the following statement:

> This information is very important to any prospective franchisee, and our failure to provide it makes it more difficult for you to make an informed decision about purchasing a franchise, as well as increases your financial risks in purchasing a franchise from us. Unless you obtain this type of information on your own, your risks may be substantial.

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[168] *See also* Duvall, Comment 19, at 2; Kaufmann, Comment 33, at 7; Jeffers, Comment 116, at 5; Zarco & Pardo, Comment 134, at 6; CA BLS, Comment 124, at 2.

[169] SBA Advocacy, Comment 36, at 8; CA BLS, Comment 124, at 2; Lagarias, Comment 125, at 4-5.

[170] Kaufmann, Comment 33, at 15.

[171] Wieczorek, 6Nov97 Tr at 183-84.

[172] IL AG, Comment 77, at 2. *See also* AFA, Comment 62, at 6.

[173] WA Securities, Comment 117, at 3; NASAA, Comment 120, at 8; Zarco & Pardo, Comment 134, at 6; Kezios, 18Sept97 Tr at 91; Tifford, 18Sept97 Tr at 91-92.

NASAA, Comment 120 at 8.[174]

Revised Financial Performance Disclosures. Based upon the record, the Commission continues to believe that financial performance disclosures should remain voluntary and that ordinary market forces are sufficient to provide an incentive for franchise systems to make performance information available to prospective franchisees.[175] At the same time, the Commission proposes to amend the Rule by adopting the greatly streamlined UFOC Item 19 approach toward financial performance representations. First, following the UFOC Guidelines, proposed section 436.5(s) would permit franchisors to make financial performance claims in the text of their disclosure documents, without the need to create separate "earnings claim" documents. Second, proposed section 436.5(s) would permit franchisors to disclose truthful information about the financial performance of all or a subgroup of franchisor-owned or franchised outlets, provided the franchisor also describes the characteristics of the included outlets that may differ materially from those of the outlet that is offered for sale. In contrast, the current Rule permits such disclosures only if the data is directly relevant to the prospective franchisee's geographic market territory.[176]

Third, proposed section 436.5(s) incorporates two UFOC Item 19 provisions that greatly facilitate franchisors' ability to provide prospects with performance information. A franchisor who provides a prospective franchisee with the actual operating results of a specific unit being offered for sale need not comply with the general Item 19 disclosure requirements provided that the franchisor gives the information only to the potential purchaser of that unit and provides the potential purchaser with the name and last known address of each owner of the unit during the prior three years. In addition, a franchisor who make Item 19 financial performance representations can provide prospective franchisees with supplemental performance representations directed at a particular location or circumstance, apart from the disclosure document, provided that the franchisor furnishes such supplemental performance representations in writing, explains how it differs from the Item 19 disclosure, follows the Item 19 format, and leaves the information with the prospective franchisee. Both of these enhancements, which have no parallel in the current Rule, make it easier for franchisors to provide prospects with material performance information narrowly tailored to the particular outlets in question.

At the same time, proposed section 436.5(s)'s financial performance disclosure provision differs from the UFOC approach in one significant way. UFOC Item 19 -- as well as the current Rule -- requires franchisors who make financial performance disclosures to state the number and percentage of the franchised outlets that have actually attained or surpassed the stated

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[174] *See also* Cordell, 6Nov97 Tr at 199-200.

[175] *See* Hogan & Hartson, Comment 28, at 7; Kaufmann, Comment 33, at 7; Tifford, Comment 78, at 5; IFA, Comment 82, at 3.

[176] *See* 16 C.F.R. §§ 436.1(b)(1); 436.1(c)(1).

performance claim. The Commission believes that this disclosure may be misleading and may actually discourage franchisors from making financial performance information available to prospective franchisees. For example, a franchisor may have statistics showing that 9 out of 10 franchised stores in a particular location (such as Seattle) average $100,000 net profit a year. Yet, the current UFOC and Rule requirements would prevent the franchisor from disclosing truthful information about the universe the franchisor has measured -- the 10 franchised outlets in Seattle. Rather, the franchisor would be forced instead to state 9 out of the entire number of all franchises nationwide (*e.g.*, 9 out of 1,000) have earned the $100,000 claimed.

This approach arguably would prevent a franchisor who does not have complete financial performance information on each and every franchise in its system from making truthful performance representations about a subset of franchisees, such as franchisees operating in a particular geographic area or operating a particular kind of unit (*e.g.*, kiosks in shopping malls). Moreover, in the example noted above, a disclosure that 9 out of 1,000 franchisees have earned the represented amount ($100,000) is misleading because it implies that 991 franchisees *have not* earned the claimed amount when, in fact, the franchisor may not have sampled or otherwise measured the remaining group of 991.

Accordingly, the Commission proposes to amend the Rule to permit a franchisor to disclose historical financial performance information in its Item 19 disclosures if there is a reasonable basis for such information and the franchisor: (1) discloses the nature of the universe of outlets measured; (2) the dates during which the reported level of financial performance was achieved; (3) the number of outlets in the universe measured during the relevant period; (4) the number of outlets from the universe measured whose performance were utilized in arriving at the representation; (5) of the number of outlets whose data was utilized, the number and percentage that actually attained or surpassed the stated results; and (6) characteristics of the included outlets that may differ materially from those being offered to the prospective franchisee.[177]

Based upon the record, the Commission also proposes to adopt the ANPR proposal that franchisors include prescribed preambles in Item 19 to clarify the law regarding financial performance claims. Among other things, the first preamble corrects the common misrepresentation that the Commission or the Rule actually prohibits the making of financial

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[177] For example, a franchisor may state a historical performance representation as follows:

> Franchised outlets in Seattle earned $100,000 in 1998.
>
> The Franchisor has sampled all of its franchised outlets in Seattle during the period 1998. The sample included 10 outlets. Nine of the 10 outlets responded. Of the nine responding franchised outlets, all attained or surpassed net profits of $100,000. We note, however, that each of the franchised outlets in Seattle has been in business for over 10 years and is located in an urban center.

performance disclosures.[178] In light of the Commission's extensive law enforcement history combating false and unsubstantiated performance claims, the Commission also believes that the first preamble is necessary to encourage prospective franchisees to consider financial performance representations made in an Item 19 disclosure only. In addition, the Commission believes that the second preamble, which is used only if the franchisor does not disclose performance information, is warranted to alert prospective franchisees that any subsequent performance claims are unauthorized and, impliedly, should not be relied upon.

The proposed revised preambles incorporate many of the suggestions offered in response to the ANPR. For example, some commenters voice concern that phrases in the original preamble such as "do not rely on" unauthorized performance information may be misinterpreted as a disclaimer of liability in those instances where salespeople routinely make false or unauthorized performance claims.[179] Accordingly, the revised preamble deletes the reference to "do not rely" in favor of a broader statement alerting prospective franchisees that a franchisor can provide financial performance data "only if the information is included in the disclosure document." The proposed revised first preamble also clarifies the law regarding financial performance disclosures by noting two exceptions to the general rule that performance claims must appear in Item 19: (1) actual records of an existing outlet for sale; and (2) supplemental performance information about a particular location. The Commission also agrees with the commenters who suggest that the second preamble include a provision encouraging prospective franchisees to report any unauthorized earnings claims to the franchisor, the Federal Trade Commission, and state authorities.[180]

t. Proposed section 436.5(t): Item 20 (Outlets and Franchisee Information). Proposed section 436.5(t) is another anti-fraud disclosure provision. Based upon UFOC Item 20, it requires franchisors to disclose in tabular form statistical information on the number of franchises and franchisor-owned outlets, including the number of franchises that have failed or otherwise ceased operations. It also requires franchisors to provide prospective franchisees with

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[178] Several commenters state that such misrepresentations are prevalent and urge the Commission to clarify the Rule to address this problem. For example, Peter Lagarias states: "I am personally aware of franchisors (and sometimes even their lawyers) stating that earnings claims are forbidden by the Commission's Rule. The Commission should clarify in the Rule that the franchisor could elect to make earnings claims but has elected not to make earnings claims." Lagarias, Comment 125, at 4. *See also* Hogan & Hartson, Comment 28, at 8; SBA Advocacy, Comment 36, at 8; AFA, Comment 62, at 5; Purvin, Comment 79, at 2; Jeffers, Comment 116, at 5; CA Bar, Comment 124, at 1.

[179] SBA Advocacy, Comment 36, at 8; CA Bar, Comment 124, at 2; Lagarias, Comment 125, at 4-5.

[180] WA Securities, Comment 117, at 3; NASAA, Comment 120, at 8; Zarco & Pardo, Comment 134, at 6; Kezios, 18Sept97 Tr at 91; Tifford, 18Sept97 Tr at 91-92.

the names and addresses of current and former franchises, with which they can verify the franchisors' representations and learn more about the franchise relationship.[181] For these reasons, the Commission agrees that Item 20 is among the most material disclosure items.[182]

Proposed section 436.5(t) enhances the less comprehensive disclosures found at 16 C.F.R. § 436.1(a)(16) by requiring franchisors to disclose the names and addresses of former as well as current franchisees. It also increases the number of franchisees about whom information is disclosed from 10 to either all or at least 100. This information prevents fraud by arming prospective franchisees with a source of information with which they can conduct their own due diligence investigation of the franchise offering. At the same time, proposed section 436.5(t) corrects a "double counting" problem in UFOC Item 20 that was identified during the Rule Review proceeding. As explained below, proposed section 436.5(t) also improves UFOC Item 20 by addressing the use of gag clauses and trademark-specific franchisee associations.

"Double Counting" Issue. During the Rule Review, commenters voiced concern that UFOC Item 20 is flawed and needs to be fixed.[183] Specifically, commenters observed that franchisors may report a change in franchise ownership in multiple categories, which may inflate the overall number of franchise closings. Accordingly, in the ANPR, the Commission acknowledged this concern and solicited comment on how UFOC Item 20 could be improved.[184]

In response to the ANPR, several commenters confirm the "double counting" problem.[185] However, only a few commenters offer concrete solutions, as noted below, and no consensus has emerged on how to correct the problem. Specifically, three commenters suggest that the Commission solve the double counting problem by adding additional categories to the Item 20 disclosure.[186] Another commenter believes that most double reporting problems are attributable

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[181] SBP, 43 FR at 59670-73.

[182] *See* Karp, 19Sept97 Tr at 95; Slimak, 22Aug97 Tr at 33.

[183] *E.g.*, Simon, RR Tr. at 223-24; Perry, RR Tr. at 263.

[184] 62 FR at 9121.

[185] *E.g.* Hogan & Hartson, Comment 28, at 6; AFA, Comment 62, at 3; IL AG, Comment 77, at 2; Tifford, Comment 78, at 4; IFA, Comment 82, at 2; Cendant, Comment 140, at 3; Karp, 19Sept97 Tr at 91.

[186] For example, Robert Zarco recommends that the Commission create 12 categories to capture various combinations of ownership changes. Transfers, for instance, would be divided into four distinct categories: (1) transfers by the franchisee to the franchisor; (2) transfers by the franchisee to the franchisor, but ultimately re-franchised; (3) transfers by the franchisee directly to a new franchisee; and (4) transfers by the franchisee directly to a new franchisee more than

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to the inclusion of transfers and reacquisitions in the UFOC Item 20 table that summarizes franchised outlets. He suggests that transfers should be reported in a separate column located on the side of the franchisee statistics table and that reacquisitions be moved to the second UFOC Item 20 table concerning company-owned outlets.[187] At the same time, this commenter suggests that franchisors report multiple ownership changes only once, according to which event was "first-in time."[188] Other commenters suggest that the Commission require franchisors to report multiple events according to a predetermined order of priority.[189] Specifically, the Commission could require franchisors to report multiple ownership changes only once, but eliminate "picking and choosing" of categories by assigning a specific order of priority such as termination, non-renewal, reacquisition, and transfer. For example, a franchisor might report an ownership change as a termination, regardless of what other events may have occurred before (abandonment of the property) or after (reacquisition or transfer).

The Commission believes that proposed section 436.5(t) fixes the double counting problem within the framework of the UFOC Guidelines. Franchisors would start the disclosure by noting the states where they have outlets (column 1) and the number of outlets opened at the beginning of the fiscal year (column 2). Franchisors then note the number of franchises with the same ownership at the end of the year (column 3). Next, franchisors report on franchisees who have left the system during the course of the term of the franchise agreement because of one of three events -- termination, reacquisition, and transfer (columns 4-6). Franchisors then report outlets that were not renewed at the end of the franchise term (column 7). To ensure that all outlets are accounted for, there is a miscellaneous category "outlets that ceased operation or closed for other reasons" (column 8). This category would capture information about events such as an abandonment of an outlet. To aid prospective franchisees in understanding the net effect of changes in ownership, franchisors also report the total number of outlets discontinued during the fiscal year (column 9). Finally, to account for franchisees that have joined the system during the fiscal year, franchisors report the total number of outlets in operation at the end of the year (column 10).

The Commission believes that proposed section 436.5(t) solves the double counting problem in a streamlined and efficient manner without increasing compliance burdens. First, proposed Item 20 addresses the core source of double counting -- imprecise reporting categories. To that end, it defines with specificity the terms "termination," "reacquisition," "transfer," and

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[186](...continued)
once. Zarco & Pardo, Comment 134, at 6-7. *See also* AFA, Comment 62, at 3; Karp, Comment 136, at 2-6.

[187] Wieczorek, Comment 122, at 2.

[188] *Id.*

[189] Simon, 18Sept97 Tr at 23-24; Tifford, *id.* at 25-26. *See also* Bundy, 6Nov97 Tr at 229.

"nonrenewal," creating mutually exclusive categories. A "termination" occurs when a franchisor sends a franchisee an unconditional notice that it will terminate the franchise agreement before the end of the agreement term. A "reacquisition" is limited to instances where the franchisee sells his or her outlet back to *the franchisor*. A "transfer," in turn, is limited to instances where a franchisee sells his or her outlets directly to a *new franchise owner*. Finally, a nonrenewal occurs when a franchisor sends a franchisee an unconditional notice that it will not renew the franchise agreement at the end of the agreement term. These proposed definitions eliminate a major source of double count: overlapping categories.[190] At the same time, the proposed definitions have the additional benefit of informing a prospective franchisee about the extent to which franchisees recoup some of their investment when they leave the system.[191]

Second, proposed section 436.5(t)(1)(xi) reduces double counting by adopting a "first-in-time" approach: when an ownership change involves two or more events, the franchisor reports only the event that occurs first.[192] For example, a franchisor may formally notify a franchisee that the franchise will be terminated on a specific date and the franchisee then transfers the outlet to a new owner. Under the "first-in-time" instruction, the termination would be considered the first event.

While the Commission proposes a chronological approach ("first-in-time") to reporting ownership changes, it nonetheless wishes to explore further the suggestion that the Commission require franchisors to report ownership changes according to a precise order of priority. The record, however, is devoid of any information from which the Commission could prioritize changes in ownership. Accordingly, the Commission seeks comment on whether the proposed first-in-time approach, coupled with precise category definitions, is sufficient to address the double counting issue, or whether the Commission should establish a specific order of priority. If an order of priority is preferred, then the Commission solicits specific suggestions for creating such a priority list.

Gag Clause Issue. In the ANPR, the Commission explored the use of gag clauses, contractual provisions that prohibit or restrict former or existing franchisees from discussing their experiences within the franchise system.[193] Recognizing that gag clauses may harm prospective franchisees by limiting their ability to conduct a due diligence investigation of the franchise

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[190] Several commenters urged the Commission to define the terms "transfers" and "reacquisitions" more precisely. IL AG, Comment 77, at 2; Tifford, Comment 78, at 4; Wieczorek, Comment 122, at 1-2.

[191] *See* Kaufmann, 18Sept97 Tr at 27; Karp, 19Sept97 Tr at 92.

[192] *See* Wieczorek, Comment 122, at 2; 6Nov97 Tr at 225-26.

[193] 62 FR at 9121.

offering,[194] the Commission asked for comment on the extent to which franchisors use gag clauses to inhibit franchisee speech, whether the Commission should modify the Rule to prohibit franchisors from using gag clause provisions, and alternatives that would ensure that prospective franchisees can freely obtain information from former and existing franchisees about their experience with the franchise system.

In response, a quarter of the commenters (42 out of 166 commenters) address the gag clause issue, the majority opposing their use.[195] In addition, several participants at the Commission staff's six public workshop conferences on the ANPR identified gag clauses as a problem. The most poignant example was a franchisee of an undisclosed franchise system who attended the Chicago public workshop conference. She told Commission staff that she had to speak quickly because she was on her way to sign a final agreement terminating her relationship with her franchisor. The termination agreement she was to sign included a gag clause.[196]

Commenters opposing the use of gag clauses, including state regulators and some franchisors, assert that such clauses inhibit prospective franchisees from learning the truth about the franchise system as they attempt to conduct their due diligence investigation of the franchise offering.[197] Attempts to restrict franchisee speech through gag clauses may deceive prospects by effectively eliminating one source of information, namely those who may have a dispute with the

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[194] *See FTC v. Orion Prod.,* Bus. Franchise Guide (CCH) ¶ 10,970 (N.D. Cal. 1997), and *FTC v. Tutor Time Child Care Sys.*, Bus. Franchise Guide (CCH) ¶ 10,971 (N.D. Cal. 1997). *Cf. FTC v. Comprehensive Accounting Corp.*, Bus. Franchise Guide (CCH) ¶ 8911 (N.D. Ill. 1987 (Defendants prohibited from "wrongfully discouraging" franchisees from giving unfavorable references to potential investors.").

[195] *E.g.,* Manuszak, Comment 13, at 1; Sibent, Comment 41, at 1 (and 19 identical comments); AFA, Comment 62 at 3; IL AG, Comment 77, at 2; Buckley, Comment 97, at 1; Marks, Comment 107, at 2; WA Securities, Comment 117, at 2; NASAA, Comment 120, at 4; Dady & Garner, Comment 127, at 2. Opponents of gag clauses include several franchisor representatives. *E.g.*, Kestenbaum, Comment 40, at 2. Cendant opposes the use of gag clauses outside of litigation, except to protect trade secrets or other proprietary information. Cendant, Comment 140, at 3.

[196] Lundquist, 22Aug97 Tr at 42-43. *See also* Maloney, Comment 38, at 2.

[197] NCL, for example, states: "Because the experience of others who have purchased a franchise or business opportunity is the best indicator of potential earnings and other factors for prospective buyers, 'gag orders' that prohibit people from sharing their experience with others should be prohibited." NCL, Comment 35, at 3. *See also* Baer, Comment 25, at 3; Karp, 19Sept97 Tr at 95-96.

franchisor or are otherwise disgruntled.[198] Indeed, a franchisor, if it wished to do so, could use gag clauses to ensure that prospects speak with only those franchisees who are successful or otherwise inclined to give a positive report.[199] In addition, one commenter contends that the harm flowing from gag clauses goes beyond individual franchise sales, noting that gag clauses intimidate franchisees against testifying before legislative committees and public agencies, such as the Commission.[200]

On the other hand, several franchisors or their representatives oppose banning the use of gag clauses. For example, one commenter contends that gag clauses prevent disgruntled franchisees from inflaming others and enable franchisors to end relationships with problem franchisees without spending considerable resources. He asserts that banning gag clauses would impede informal settlements between franchisors and franchisees.[201] Other commenters note that franchisors must have the ability to protect their trade secrets from disclosure.[202]

Other commenters offer a variety of suggestions on how the Commission might address the use of gag clauses short of an outright ban. For example, a few commenters suggest that franchisors should note in their Item 20 which specific franchisees are subject to a gag clause provision. Such a requirement would accomplish two goals simultaneously. It would alert prospective franchisees that the franchisor may require its franchisees to sign gag clauses, and it would save prospects the time and trouble of trying to contact franchisees who, in fact, are not

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[198] For example, Roger Haines, a Scorecard Plus franchisee, states:

> I had spoken to some of the franchisees that had left the system. I now feel certain that they painted a picture that was not close to being the truth based on the gag order that [the franchisor] imposed. Had I gotten the truth from these people, my decision certainly would have been different. Every franchisee leaving the system has had a gag order placed on them, making it impossible for current and future franchisees to get the facts.

Haines, Comment 100, at 2.

[199] *See* NASAA, Comment 120, at 4.

[200] Selden, Comment 133, Appendix B, at 2.

[201] Kaufmann, Comment 33, at 5-6. *See also* Tifford, Comment 78, at 3; IFA, Comment 82, at 2; Duvall, 6Nov97 Tr at 247; Gitterman, 6Nov97 Tr at 250-51.

[202] Baer, Comment 25, at 3. Even franchisee advocates recognize franchisor's legitimate need for trademark protection. *E.g.*, AFA, Comment 62, at 3; Zarco & Pardo, Comment 134, at 4.

free to speak.[203] In response, however, one commenter contends that such an approach would be unnecessarily burdensome, observing that franchisors would have to update their disclosures more frequently, especially in franchise registration states.[204]

As an alternative, several comments suggest that franchisors disclose the number and percentage of current and former franchisees subject to gag clauses. Indeed, of the various proposals suggested in response to the ANPR and during the public workshop conferences, a general disclosure about the use of gag clauses garnered the most support.[205] Finally, one commenter adds that franchisors should disclose the use of gag clauses over a period of three years in order to highlight a pattern or trend in their usage. He observes: "the fact that 1 out of 100 of 1996's former franchisees had a gag order does not really fairly present the picture if you have 80 out of 100 in 1995." Bundy, 6Nov97 Tr at 257. Rather, franchisors should present information that would reveal a trend.

Based upon the record, the Commission proposes to modify UFOC Item 20 to require franchisors to disclose information about their use of gag clauses, which bar franchisees from speaking with others about their personal experiences as franchisees.[206] The Commission finds

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[203] *See* Cordell, 6Nov97 Tr at 247-48; Kezios, *id.* at 256. *See also* NASAA, Comment 120, at 4.

[204] Wieczorek, 6Nov97 Tr at 258-59.

[205] Zarco & Pardo, Comment 134, at 4. Similarly Howard Bundy adds that "[i]n a perfect world I would have a list of those that are subject to [gag clauses], so I didn't have to make all those extra 75 calls. But I could live with or without that. It's more important to disclose the fact that they do exist." Bundy, 6Nov97 Tr at 249. *See also* Selden, Comment 133, Appendix B, at 2; Jeffers, 6Nov97 Tr at 251-52. *See also* Wieczorek, 6Nov97 Tr at 260.

[206] The term "gag clause" is defined in proposed section 436.3(k) as: "any contractual provision entered into by a franchisor and a current or former franchisee that prohibits or restricts the franchisee from discussing his or her personal experience as a franchisee within the franchisor's system. It does not include confidentiality agreements that protect the franchisor's trademarks or proprietary information."

that such clauses are widespread in termination agreements and dispute settlements.[207] Neither the current Rule or UFOC Guidelines addresses this issue.

Proposed section 436.5(t)(6) provides that a franchisor must disclose the existence of gag clauses if, within the last three fiscal years, franchisees have signed gag clause provisions in any agreement, settlement, or other contract. In addition, the franchisor must state the consequences to the prospective franchisee, namely that current and former franchisees may not be able to speak freely about their experiences. To add flexibility, the Commission proposes further that the franchisor be permitted to disclose the number and percentage of its current and former franchisees in each of the last three years that are subject to a gag clause. This optional disclosure would enable a franchisor to disclose how widespread the use of gag clauses is in its system. For example, a franchisor might wish to disclose such data to demonstrate that its franchisees sign gag clauses in isolated instances only, or that the trend is away from using such clauses. At the same time, proposed section 436.5(t)(6) would also permit a franchisor to explain its use of gag clauses. The Commission believes that a bald risk factor or disclosure about the number and percentage of franchisees under a gag clause arguably may be misleading and prejudicial to a franchisor.[208] For example, a franchisor conceivably may enter into an agreement containing a gag clause only at the request of the franchisee during the course of negotiations. The Commission believes that a franchisor should be able to clarify any disclosures about gag clauses with additional, truthful information that puts the use of gag clauses into a proper context.

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[207] For example, one franchisee signed an agreement upon termination that contained the following clause:

> The Slimak parties shall not make any derogatory or disparaging action or make any false, derogatory, or disparaging comment, publicly or privately, concerning the Jacadi parities, or any of the directors, officers, shareholders, affiliates, employees, agents, consultants, successors, or assigns or Jacadi products . . . . If questioned by any third party as to the circumstances surrounding the termination of the franchise agreement, The Slimak Parties shall state only that the parties mutually agreed to terminate their commercial relationship.

Slimak, Comment 130, at 1. *See also* Doe, 7Nov97 Tr at 276.

[208] Two commenters suggest that the Commission require a disclosure about gag clauses only if the number of franchisees subject to such clauses surpasses some threshold. They imply that isolated instances of gag clause usage may be misleading to prospective franchisees or prejudicial to the franchisor. *See* Bundy, 6Nov97 Tr at 249; Jeffers, *id.* at 251-52. The Commission believes that the flexibility offered by proposed section 436.5(t)(6), in particular the franchisor's ability to explain when it uses gag clauses, appears sufficient to address this concern.

Franchisee Association Issue. In response to the ANPR, a number of franchisees and their advocates urge the Commission to revise UFOC Item 20 to require the disclosure of trademark-specific franchisee associations. In some instances, these organizations are recognized councils approved by the franchisor, where franchisee-participants are selected by the franchisor or are elected by the system's franchisees. In other instances, the organizations are independent of the franchisor.[209] One commenter explains the need for such a disclosure as follows:

> The UFOC Guidelines currently require disclosure of the existence of purchasing cooperatives known to the franchisor, but this is not adequate disclosure of a fact of growing importance to franchisees, which is the existence, or non-existence, of an autonomous franchisee association representing franchisees in that particular franchise organization. When an organization represents a substantial plurality of franchisees in the system, perhaps over 30%, and its existence is known to the franchisor, that fact should be disclosed, possibly by an additional category in the list of existing franchisees required in item 20, as an additional and critical source of information about the franchise opportunity.

Selden, Comment 133, Appendix B. at 1.[210]

Franchisors generally do not oppose a disclosure for trademark franchisee associations, especially franchisor-sponsored franchisee advisory councils and recognized independent franchisee associations. However, they voice concern about any mandate to disclose independent franchisee associations. They assert that such organizations are often small, informal groups that come and go, or organizations formed on the local or regional level without the knowledge of the franchisor.[211] In short, they fear liability for failing to disclose the existence of groups that they do not know exist.

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[209] Not all independent franchisee associations are well-received by the franchisor. Indeed, some commenters have told us that in some instances franchisors have filed suit to stop the formation of an independent group or have retaliated against individuals who have participated in such groups. *E.g.*, Donafin, Comment 14, at 1. *See also* Mueller, Comment 29, at 1-2; Bell, Comment 30, at 1; Rachide, Comment 32, at 3.

[210] Similarly, Martin Cordell, a franchise examiner for the State of Washington, observes that disclosing trade associations could "be a much more ready source of information as opposed to individual franchisees who have to take time out of their businesses to share information with the prospective franchisee." Cordell, 6Nov97 Tr at 168-69. Similarly, Susan Kezios of the AFA told us that associations "have a collective memory of what has been going on historically in the franchise system that one or another individual franchisees may or may not have." *Id.* at 176. *See also* Manuszak, Comment 13, at 1; Zarco & Pardo, Comment 134, at 3; Kezios, 6Nov97 Tr. at 168; Wieczorek, 6Nov97 Tr at 170; Bundy, *id*. at 173.

[211] Shay, 18Sept97 Tr at 71; Wieczorek, 6Nov97 Tr at 169-70; Duvall, *id* at 171.

Based upon the record, the Commission agrees that franchisors should disclose the existence of trademark-specific franchisee associations.[212] The Commission has long recognized that the names and addresses of current franchisees is material information, enabling prospective franchisees to conduct their own due diligence investigation of the franchise system. Providing prospective franchisees with information about an organized group of franchisees is a logical extension, giving franchisees yet an additional source of material information from which they can learn about the system, especially franchisees' financial performance history. This disclosure is particular important if individual former and existing franchisees of a system are subject to gag clauses or are otherwise reluctant to talk with prospective franchisees.[213]

The Commission believes proposed section 436.5(t)(7) strikes the right balance between providing disclosure to prospective franchisees and eliminating franchisors' potential liability for failing to disclose the existence of franchisee organizations that are unknown to them. It would require franchisors to disclose organizations whose existence is known to them either because the franchisor sponsors the organization or formally recognizes the organization. In addition, it would require the franchisor to disclose incorporated, independent franchisee associations, but only to the extent that such organizations make their existence known to the franchisor on an annual basis. This would eliminate franchisors' concerns about having to disclose every small, informal group of franchisees by limiting the disclosure to incorporated organizations, which are more likely than unincorporated organizations to have an "institutional history," as well as the time and inclination to speak with prospective franchisees. It would also shift the burden to the franchisee association to ask specifically to be included in the franchisor's disclosure document. The Commission believes that this approach would relieve franchisors of the burden of, and potential liability associated with, having to identify such organizations. To further reduce compliance costs and burdens, proposed section 436.5(t)(7) makes clear that a franchisor must list the franchisee organization in its disclosure document to be used in the next fiscal year only. This relieves franchisors of the burden of having to verify the continued existence of the organization in the future. In short, a franchisee organization would have the burden to renew its request for inclusion in the disclosure document on an annual basis.

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[212] The Commission is not suggesting that franchisors disclose the existence of broad-based associations that represent franchisee interests generally, such as the American Franchisee Association or the American Association of Franchisees & Dealers.

[213] The record indicates that franchisees may be reluctant to share information about their system with prospective franchisees either because they do not have the time, or because they fear retaliation from their franchisor. For example, Howard Bundy told us that he often instructs his franchisee clients to state only their "name, rank, and serial number and refer [the prospect] back to the franchisor for everything else." Mr. Bundy explains that franchisees who make statements in connection with a franchise sale might be deemed franchise brokers under state law and could be liable for any claims or damages resulting from the sale. He also fears that franchisees who volunteer information might be subject to a defamation suit by the franchisor. Bundy, 6Nov97 Tr at 236-37.

u. Proposed section 436.5(u): Item 21 (Financial Statements). Based upon UFOC Item 21, proposed section 436.5(u) requires the disclosure of audited financial information based upon generally accepted accounting principles. It improves the comparable Rule disclosures currently found at 16 C.F.R. § 436.1(a)(20) by requiring franchisors to present financial disclosures in columns that compare at least two fiscal years. This will enable prospective franchisees to analyze better the franchisor's fiscal status by seeing at a glace a broad snap-shot of the company's historical earnings performance.

At the same time, the Commission proposes to modify the Rule to clarify the Commission's three-year phase-in of audited financial statements.[214] In the ANPR, the Commission solicited comment on whether the Commission should retain the phase-in.[215] Without exception, the commenters who address this ANPR issue continue to support a three-year phase-in,[216] and no commenter offers any refinements or alternatives to the Commission's current phase-in approach.

The proposed phase-in clarifies and streamlines the Commission's current phase-in provision in several ways. As with the current phase-in, franchisors will be allowed two fiscal years before they are required to provide full audited financial statements. The proposed phase-in, however, eliminates the arguably confusing current distinction between a franchisor's first "partial" or "full" fiscal year by collapsing "partial" and "full" fiscal years into one category. Under this proposal, all franchisors will be required to include audited financial statements in their disclosure documents by their third year, whether or not their first fiscal year was a partial or full year. The proposed phase-in also clarifies the Rule by setting forth the phase-in schedule in a clear and easy-to-understand table. This should enable franchisors to understand quickly the Rule's phase-in requirements. The Commission believes that the proposed phase-in of audited financial statements not only reduces compliance costs for start-up franchise systems, but effectively removes a potentially significant barrier to entry.

v. Proposed section 436.5(v): Item 22 (Contracts). Proposed section 436.5(v) incorporates UFOC Item 22.[217] It is also is substantially similar to the current Rule instruction found at 16 C.F.R. § 436.1(g). It prevents fraud by requiring franchisors to attach copies of all agreements pertaining to the franchise sale, such as the franchise agreement and any leases,

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[214] 16 C.F.R. § 436.1(a)(20)(ii).

[215] 62 FR at 9121.

[216] *E.g.*, Duvall, Comment 19, at 1; Baer, Comment 25, at 4; Kaufmann, Comment 33, at 6; Kestenbaum, Comment 40, at 2; AFA, Comment 62, at 3; IL AG, Comment 77, at 3; Tifford, Comment 78, at 4; IFA, Comment 82, at 1; Jeffers, Comment 116, at 2.

[217] In response to the ANPR, no commenter raised any concerns about UFOC Item 22, upon which proposed section 436.5(v) is based.

options, or purchase agreements. This enables prospective franchisees to compare what the franchisor represents in its disclosures about the franchisor's and franchisee's legal obligations with the actual agreements that will govern the franchise relationship.[218]

w. Proposed section 436.5(w): Item 23 (Receipt). Proposed section 436.5(w) incorporates the UFOC Guidelines' Item 23 receipt requirement.[219] There is currently no comparable Rule requirement. The Commission believes that proposed section 436.5(w) will serve an important anti-fraud purpose. The Commission's law enforcement experience indicates that franchisees in many instances claim that they never received a copy of the franchisor's disclosure document. A requirement that franchisees acknowledge receipt of the disclosure document will better ensure that franchisees actually receive the disclosures with all required attachments. The receipt also serves an important consumer education function, informing prospects that they have 14 days to review the disclosures, that franchisees should receive certain attachments, and that franchisees can report possible law violations. Further, as explained below, a receipt is necessary to prove delivery in the event that a franchisor chooses to make disclosures via the Internet.[220]

At the same time, the Commission believes that the UFOC Item 23 receipt should be modified to afford franchisees greater flexibility in acknowledging receipt of a disclosure document. To that end, proposed section 436.5(w) would allow prospective franchisees to acknowledge receipt through a "signature." As explained *supra* at Section C.4.w., the Commission proposes to define the term "signature" to include not only written signatures, but digital signatures, passwords, security codes, and other devices that will enable a prospective franchisee to easily acknowledge receipt, confirm their identity, and submit the information to the franchisor. Proposed section 436.5(w) also provides that franchisors may include specific instructions on how to submit the receipt, such as via facsimile. This would enable the parties to determine for themselves the most efficient way for the prospective franchisee to acknowledge receipt.

Proposed section 436.5(w) also adds two new provisions. First, section 436.5(w)(2) provides that franchisors shall obtain a signed copy of the receipt at least five days before the prospective franchisee signs the franchise agreement or pays any fee in connection with the franchise sale. In effect, franchisors must have the signed receipt at the time they furnish prospective franchisees with the completed franchise agreement. The Commission believes this

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[218] In the SBP, the Commission recognized that this requirement "will therefore have a remedial effect in that it will encourage accurate discussion of the required information in the disclosure statement." 43 FR at 59696.

[219] In response to the ANPR, no commenter voiced any concerns about UFOC Item 23, upon which proposed section 436.5(w) is based.

[220] *See infra* Section C.10.b.

provision is necessary to ensure that the prospective franchisee receives the disclosures in a timely fashion. It also prevents fraud by effectively prohibiting franchisors from requiring franchisees to backdate the disclosure document receipt after the sale has been completed. Finally, section 436.5(w)(3) adds a minor recordkeeping provision, requiring franchisors to retain a copy of the signed receipt for a period of at least three years. This provision is necessary in order for franchisors to prove compliance with the rule's disclosure and timing provisions. The Commission believes that this requirement should not impose any significant costs or burdens on franchisors, who generally would retain a copy of the receipt as a standard business practice, especially to comply with the laws of many franchise registration states that require franchisors to keep records of each franchise sale.

9. Proposed section 436.6: Instructions For Preparing Disclosure Documents

The next section of the proposed Rule sets forth the basic instructions for preparing a disclosure document. For the most part, the existing Rule instructions are unchanged.

a. Proposed section 436.6(a): Plain English. Proposed section 436.6(a) adopts the UFOC's requirement that disclosure documents be written in plain English. The plain English requirement is also consistent with the efforts of the federal government's National Performance Review to make all federal rules and regulations easier to understand.[221] The definition of the term "plain English" is discussed *supra* at Section C.4.q.

b. Proposed section 436.6(b): Responses. Proposed section 436.6(b) directs franchisors to respond to each required disclosure item, either positively or negatively. Except for minor editing, proposed instruction 436.6(b) is identical to the current Rule provision found at 16 C.F.R. § 436.1(a)(24).

c. Proposed section 436.6(c): No Additional Materials. The first part of proposed section 436.6(c) specifies that franchisors may not include additional information in the disclosure document except for information required by non-preempted state law. This part is identical to the current Rule provision found at 16 C.F.R. § 436.1(a)(21). The remainder of the instruction makes clear that franchisors preparing multi-state disclosures may include state-specific information in an attachment to their basic disclosure document. This instruction reduces compliance burdens and costs because franchisors need not generate disclosure

[221] *See* <www-a.blm.gov/nhp/NPR/plaine.html>. Indeed, several agencies already have incorporated plain English requirements in their rules and guides. *See, e.g.,* <www.sec.gov/consumer/plaine.htm> (SEC plain English guides); <www.irs.ustreas.gov/basic/tax-regs/reglist.htm> (Internal Revenue Service plain English guides).

documents tailored for each state. This approach is consistent with several instructions found throughout the UFOC Guidelines.[222]

d. Proposed section 436.6(d): Subfranchisors. Proposed section 436.6(d) addresses disclosure obligations pertaining to subfranchisors. Specifically, it requires subfranchisors to disclose the required information about the franchisor and, to the extent applicable, the same information about the subfranchisor. This is consistent with current Commission policy,[223] as well as the UFOC Guidelines.[224]

10. Proposed section 436.7: Instructions for Electronic Disclosure Documents

Proposed section 436.7 sets forth instructions to enable franchisors to comply with the Franchise Rule electronically. In the ANPR, the Commission solicited comment on how franchisors might comply with the Franchise Rule via the Internet.[225] In response, two commenters offer substantially similar proposals, recommending that the Commission permit compliance via the Internet in at least the following scenario: (1) the franchisor has a web site that provides general information about its franchise system; (2) individuals interested in being considered for a franchise can fill out and transmit an online application; (3) applicants deemed by the franchisor to be serious prospects would be given a password to gain access to a section of the web site containing disclosure documents; and (4) the applicant reviews the appropriate disclosure document online.[226]

The Commission does not wish to impede franchisors' ability to maximize the use of new technologies in their efforts to comply with the Rule. The Commission, therefore, proposes that franchisors be free to use electronic media to furnish their disclosures to the fullest extent possible.[227] As the Commission recognized in its Internet Notice, electronic transmission of

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[222] *See, e.g.,* UFOC Cover Page Instructions; UFOC Item 1C Instructions.

[223] *See* Final Interpretive Guides, 44 FR at 49969.

[224] *See* UFOC Guidelines, General Instructions 230 and 240.

[225] 62 FR at 9122.

[226] Su, Comment 24; PR One, Comment 105.

[227] To that end, the proposed Rule adds three new definitions. *See supra* at Section C.4. First, the term "written" has been revised to include all media that are capable of being printed and read. Second, the Commission has added the "Internet," which is defined to include all communications between computers and between computers and other communications devices. Finally, the term "signature," includes electronic signatures, passwords, and other devices as a substitute for the traditional handprinted signature.

disclosures may be "easier, more efficient, and less costly to industry members."[228] Electronic disclosure would also greatly reduce perhaps the chief costs imposed by the Rule: printing and distribution costs.

As explained below, the Commission proposes no new sweeping requirements in this area. Rather, proposed section 436.7, for the most part, elaborates upon concepts that are already part of the Rule, in particular how to "furnish" disclosures electronically and how to prepare "clear," "concise," and "legible" disclosures in an electronic environment. Nonetheless, in order to prevent fraud and circumvention of the Rule's pre-sale disclosure requirements, the proposed Rule contains two new, modest requirements: (1) that franchisors using electronic media provide prospective franchisees with a paper summary document containing an expanded cover page, table of contents, and acknowledgment of receipt, and (2) that franchisors retain a specimen hard copy of each materially different version of their disclosures.

a. Proposed section 436.7(a): Consent. Proposed section 436.7(a) makes clear that a franchisor can furnish disclosures electronically only if it obtains the prospective franchisee's informed consent.[229] It also provides that prospective franchisees retain the right to revoke acceptance of an electronic disclosure document for any reason and obtain a paper copy up until the time of the franchise sale.

The Commission believes that the obligation to furnish disclosures would be a hollow one if franchisors could force prospective franchisees to receive disclosures in an electronic format that they cannot actually receive or read.[230] The Commission is also concerned that fraudulent operators will gravitate toward electronic media as a new way to avoid pre-sale disclosure. For example, a scam artist could decide to furnish its disclosures only in some obscure format that is essentially unaccessible to most prospective franchisees. In keeping with the Rule's very purpose -- to prevent fraud -- the Commission believes that candidates for a franchise who are trying to conduct their own due diligence investigation should be able to

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[228] 63 FR at 25001.

[229] For example, the Commission expects a franchisor to disclose in advance the medium used to furnish its disclosures (such as computer disk, CD-ROM, E-mail, or Internet) and any specific applications necessary to view the disclosures (such as Windows 95, or DOS, or a particular Internet browser).

[230] This proposal is similar to the position adopted by the SEC with respect to federal securities regulations. *See* Use of Electronic Media For Delivery Purposes, SEC Release No. 33-7233, 60 FR 53458 (October 13, 1995)("SEC Release"), formally adopted in SEC Release No. 33-7289, 61 FR 24652 (May 15, 1996), which advises the securities industry how it may use electronic media to deliver information (*i.e.*, prospectuses and proxy materials) required under various federal securities statutes. A copy of the SEC release is found at <http://www/sec.gov/rules/proposed/33-7233.txt>.

review a hard copy disclosure document if that medium is more convenient to them. Disclosure documents are often very lengthy and prospective franchisees may have difficulty reading the document on screen or downloading the document onto a disk. Some prospective franchisees simply may not wish to pay the cost to print the disclosure document from their computer screen. Until such time as electronic media are more widely used, and consumers are more comfortable with such media, the traditional paper copy should remain available as an option.

In the same vein, the Commission believes that franchisees should have the ability to revoke acceptance of an electronic disclosure document in favor of a paper copy up until the time of the sale.[231] Requiring franchisors to provide prospective franchisees with a paper copy should not impose any significant burdens or costs. If a prospective franchisee finds that he or she cannot easily read a disclosure document electronically, it would be relatively easy, and cost little, for the franchisor to print a copy of its electronic version and mail it to the prospect.[232] This proposal is consistent with the Commission's Internet Notice, where the Commission recognized that:

> The requirement that certain information should be provided to another person implies that such information actually be received by that person. Therefore, although it may be advantageous to use new technology to comply with affirmative [disclosure] requirements, industry members should be mindful of certain issues. For example, the requirement to give, mail, deliver, or furnish information would not be met if the intended recipient does not have the technological capabilities of receiving or viewing the information. In certain circumstances, industry members may need to obtain the recipient's consent to deliver information by a certain electronic method, inform the recipient of any particular medium applications needed to view the information, or deliver the information on paper.

63 FR at 25001.

Finally, to ensure that prospective franchisees are notified about their right to receive a paper copy, proposed section 436.3(g) requires any franchisor seeking to furnish disclosures electronically to add the following provision to their cover page:

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[231] *See* SEC Release, 60 FR at 53460-61. Similarly, the Federal Reserve agrees in principle that consumers should be able to get a paper copy of electronic transfer disclosures, stating that it "expects that financial institutions will accommodate a consumer's request for a paper copy, or that they will redeliver disclosures electronically, to the extent that it is feasible to do so." *See* Interim Rule on Electronic Fund Transfers ("EFT Rule"), implementing the Electronic Fund Transfer Act, 15 U.S.C. 1693 *et seq.* (1978), 63 FR 14528, 14530 (March 25, 1998). *See also* Selden, Comment 133, at 3; Zarco & Pardo, Comment 134, at 5.

[232] *See* Wieczorek, 6Nov97 Tr at 61; Duvall, *id.*, at 62-63.

You may have elected to receive an electronic version of your disclosure document. If so, you may wish to print or download the disclosure document for future reference. You have the right to receive a paper copy of the disclosure document up until the time of the sale. To obtain a paper copy, contact [name] at [address] and [telephone number].

Thus, prospective franchisees who wish to revoke acceptance of an electronic disclosure document for any reason will know whom to contact to receive a paper copy.

b. Proposed section 436.7(b): Notice and Receipt. Proposed section 436.7(b) requires a franchisor who furnishes disclosures electronically to provide prospects with a paper summary document containing the following three items from its disclosure document: (1) the cover page, (2) the table of contents, and (3) the Item 23 receipt. Franchisors already prepare these three items as part of their disclosure document and should be able to produce the summary document at a relatively low cost. The Commission believes the proposed summary document requirement serves two anti-fraud purposes: (1) advance notice of the importance of the information being disclosed; and (2) proof of receipt.

Based upon the Commission's law enforcement experience, it appears that many prospective franchisees are unaware of the Franchise Rule or that they should receive pre-sale disclosures. The Rule currently addresses this problem by requiring a cover page that conspicuously states, among other things, the name of the franchisor, that the document contains important information, and certain cautionary messages. In addition, the table of contents provides a summary of the types of disclosures contained in the document. The Commission believes that a prospective franchisee is more likely to read the disclosures if he or she knows that it contains information such as the franchisor's litigation history (Item 3), financial performance information (Item 19) and statistics on franchisees in the system (Item 20).

The proposed paper summary document would serve the same consumer education function, alerting the prospective franchisee to the importance of the electronic disclosures. Unlike a paper disclosure document -- which clearly announces its contents on the cover page -- an electronic disclosure document does not impart any information unless and until the prospective franchisee actually assesses it by opening a file or otherwise calling it up on a computer screen. The Commission is concerned that this might provide scam artists with a new fertile ground to commit fraud. For example, a franchise seller may seek to furnish disclosures under the Rule by simply handing a prospect an unmarked computer disk, without any further explanation. In such an instance, the prospect may fail to read the disclosures contained on the disk, or, worse, might discard the disk, because nothing draws his or her attention to the importance of the information contained on the disk. Similarly, a franchisor, in theory, might seek to comply with the Rule by verbally telling a prospective franchisee to visit the franchisor's

web site to view the franchisor's disclosure document, or by scrolling through a copy of its disclosure document online during a presentation in a hotel room.[233]

To combat such potential fraud, proposed section 436.7(b) requires franchisors offering electronic versions of their disclosure documents to provide prospective franchisee with a paper summary document. Armed with the paper summary, the prospective franchisee would realize that: (1) they should receive disclosures; (2) the franchisor's Internet addresses (*i.e.*, E-mail and web site); (3) they have at least 14 days to review the disclosures; and (4) information on how to get a paper copy. For additional protection, section 436.7(b)(2) requires that the franchisor's receipt be incorporated into the summary document. This would prevent a franchisor from having a prospect sign only the receipt, without the benefit of reviewing the important consumer educational messages contained in the cover page, as well as in the table of contents.

In addition to serving a consumer education function, the summary document is necessary to prove delivery and receipt of the disclosures. Unlike paper disclosure documents, there is no certainty that prospective franchisees will actually receive disclosures that are sent via E-mail or made available over the Internet. As the Commission recognized in its Internet Notice:

> Because there may be technological difficulties that could impede the electronic delivery of information, it may be necessary for industry members to confirm that the recipient in fact received the information. Most facsimile machines routinely confirm when the facsimile has been successfully transmitted. Senders, for example, might require recipients to confirm receipt by return e-mail or verify in some manner the recipients' access to information posted on the Web site.

63 FR at 25001.

The proposed Rule would provide prospective franchisees with several options for acknowledging receipt of the disclosure document. Prospective franchisees of course could sign the receipt in either the paper summary document or Item 23 of the disclosure document. Proposed section 436.7(b)(1)(iii) would also enable prospective franchisees to "sign" the receipt in the disclosure document electronically. As discussed above, the term "signature" is defined broadly to include not only the traditional written signature, but digital signatures and other

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[233] The Federal Reserve has also expressed concern about disclosures posted on the Internet without prior notice: "Simply posting information on an Internet site without some appropriate notice and instructions about how the consumer may obtain the required information would not satisfy the [disclosure] requirement." 63 FR at 14529. Similarly, the SEC has stated that stock issuers and others providing electronic delivery of information should have "reason to believe that any electronic means so selected will result in the satisfaction of the delivery requirements." SEC Release, 60 FR at 53461-62.

identity verification devices, such as passwords or security codes.[234] This differs from the UFOC Guidelines, which permits a written signature only.

While the Commission believes that franchisors and prospective franchisees should be able to take advantage of new technologies, it nonetheless rejects the suggestion that a franchisor be permitted to demonstrate receipt through "electronic verification," such as embedding a code in a disclosure document that would send a signal to the franchisor once an electronic disclosure documents has been opened.[235] The Commission believes that prospective franchisees should take some affirmative step to acknowledge receipt and confirm their identify. The acknowledgment of receipt serves not only as proof of delivery, but, as discussed above, a consumer education vehicle. For example, the acknowledgment form reminds the prospect that he or she is to receive supplemental documents along with the basic disclosure document, such as contracts or lease agreements. It also informs the prospect to report any inaccuracies in the disclosure document to the Commission and state authorities. These potential benefits to prospective franchisees might be lost if the franchisor could prove delivery solely through electronic verification. Requiring a prospect to sign the acknowledgment would better ensure that the prospect has actually read the acknowledgment page.

c. Proposed section 436.7(c): Preservation of Disclosures. Proposed section 436.7(c) requires franchisors to ensure that an electronic version of a disclosure document must be capable of being printed, downloaded, or otherwise preserved as one single document. The Commission believes that the concept of "furnishing" disclosures implies that prospective franchisees will receive a document that can be preserved for future reference.[236] This requirement is particularly important with respect to disclosures disseminated via the Web (which are often transitory), especially if the franchisor does not maintain an online archive of its disclosure documents.

d. Proposed section 436.7(d): Single Document. Proposed section 436.7(d) makes clear that electronic disclosures, like hard copies, must be capable of being reviewed as a single, self-contained document. This proposal is analogous to the Internet Notice's discussion of unavoidability, where the Commission stated:

> to ensure effectiveness, disclosures ordinarily should be unavoidable by consumers acting reasonably. On the Internet or other electronic media, this means that consumers viewing an advertisement should necessarily be exposed to

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[234] *See* 63 FR at 14531.

[235] For a description of electronic verification, see Gerdes, 6Nov97 Tr at 79-82; Jeffers, *id.* at 86-87.

[236] The Federal Reserve has come to a similar conclusion. *See* 63 FR at 14530. *See also* Bundy, 6Nov97 Tr at 129.

> the disclosure in the course of a communication without having to take affirmative action, such as scrolling down a page, clicking on a link to other pages, activating a "pop up," or entering a search term to view the disclosure.

63 FR at 25003.

The Commission recognizes that a franchisor, in theory, could divide its disclosures into separate documents that are hyperlinked together or accessed through a pop-up screen or other device. However, the Commission believes that prospective franchisees reviewing electronic disclosures should not have to surf the franchisor's web site or take affirmative action to access the required disclosures. In addition, if a prospective franchisee sought to download or print the disclosure document for future reference, disclosures contained in a separate, but linked text, would most likely be excluded. In short, any impediment to the prospect's ability to review all portions of a disclosure document online or to preserve the text as a single document would render the document an ineffective communication.

e. Proposed section 436.7(e): Features. Proposed section 436.7(e) addresses the use of special features available in electronic media. Many special features exist in an electronic environment, such as audio, video, graphics, pop-up screens, and scrolling messages. Proposed section 436.7(e) limits the use of special features to those that will assist a prospective franchisee to navigate through a disclosure document, such as internal hyperlinks, scroll bars, and search functions. Such features are the functional equivalent of leafing through a hard-copy document. In other respects, however, an electronic disclosure document must be unadorned. The Commission is concerned that, if permitted, franchisors could use graphics, animation, audio, video, and other features to call attention to favorable portions of their disclosure document or to distract prospects from damaging disclosures -- such as litigation (Item 3) and franchisee failure rates (Item 20).[237]

f. Proposed section 436.7(f): Accessibility. Proposed section 436.7(f) requires that electronic disclosures remain accessible at least until the time of the sale. The concept of "furnishing" disclosures implies that prospective franchisees will receive a document that can be reviewed at will. The Commission is concerned that a scam artist, for example, may embed a code or a virus in a computer disk that will effectively destroys its contents. Similarly, as noted above, disclosure documents posted on the Internet are often transient: A disclosure document used one day may be updated the next. It is also possible that a franchisor, for some reason, may simply decide to suspend disseminating its disclosures online, leaving prospective franchisees who have agreed to accept disclosures via the Web without any ability to access the disclosures.

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[237] This recommendation is consistent with the current Rule's prohibition on adding any material to the disclosure document beyond what is specifically required by the Rule. 16 C.F.R. § 436.1(f).

At the same time, the Commission recognizes that any obligation on the franchisor's part to ensure that electronic documents remain accessible should be limited. For example, a document posted on the Internet may become inaccessible not because of any action taken by the franchisor, but because of the consumer's computer problems or because of system failures. Accordingly, proposed section 436.7(f) makes clear that technical failures beyond the franchisor's reasonable control (such as system crashes) will not render a document inaccessible. Further, the Commission recognizes that franchisors are under obligations to update their disclosure documents periodically. A requirement that disclosures remain accessible indefinitely arguably may result in franchisors having to post multiple versions of its disclosures on the Internet to ensure that each prospective franchisee has continued access to his or her particular version. The Commission doubts that the costs and burdens of such a requirement would be outweighed by any benefits. Accordingly, proposed section 436.7(f) also makes clear that updating disclosure documents on the Internet will not render a previously posted disclosure document inaccessible. As long as a prospective franchisee has access to the franchisor's current disclosure document, that should suffice.

g. Proposed section 436.7(g): Record Retention. Proposed section 436.7(g) requires franchisors who furnish electronic disclosures under the Rule to comply with a modest recordkeeping requirement. Specifically, franchisors must maintain a specimen copy of each materially different version of their disclosures for three years. The Commission believes that a limited record retention requirement is necessary for effective law enforcement. For example, one commenter observes that "only about 24 to 25 percent of [franchise systems] are likely to be here five years from now."[238] Franchisors merge, go into bankruptcy, sell their assets, and maintenance of old records becomes very difficult, "particularly if they are available only in electronic form." He further observes that "[e]lectronic form of documents is evolving at such a rapid clip that something that is available in Microsoft Word 97 today may not be readable in Microsoft Word 99 tomorrow."[239] In short, he advocates a recordkeeping requirement in order to enable a franchisee to be able to show (and ultimately prove) what form of document he or she relied upon.

The Commission agrees. While the Rule currently does not require a franchisor to keep copies of its disclosure documents, it does require a franchisor to make copies of its disclosures (and financial performance claims substantiation) available to the Commission upon request. Franchisors also routinely keep copies of their disclosure documents, without federal oversight, for their own business records[240] and to comply with state record retention requirements. It is not unreasonable to expect franchisors to retain copies of their disclosures in order to mount a defense to a Commission, state, or private action. Moreover, any minimal recordkeeping costs

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[238] Bundy, 6Nov97 Tr. at 58.

[239] *Id.*

[240] *See* Houston-Aldridge, 6Nov97 Tr at 130-31.

associated with electronic disclosures would be substantially outweighed by the vast savings in reduced, or eliminated, printing and distribution costs associated with disseminating paper disclosure documents.

11. Proposed section 436.8: Instructions for Updating Disclosure Documents

The last of the instructions sections -- proposed section 436.8 -- concerns disclosure updating requirements. With one exception, as discussed below, the updating requirements are identical to the instructions already contained in the current Rule.

a. Proposed section 436.8(a): Annual Updates. Proposed section 436.8(a) sets forth the basic updating requirement that franchisors must revise their disclosures 90 days after the close of the fiscal year. This instruction is identical to the current Rule updating requirement set forth at 16 C.F.R. § 436.1(a)(22).

b. Proposed section 436.8(b): Quarterly Updates. Proposed section 436.8(b) provides that franchisors must update their disclosure documents to reflect any material changes on at least a quarterly basis. This instruction is also identical to the current Rule updating requirement set forth at 16 C.F.R. § 436.1(a)(22).

c. Proposed section 436.8(c): Material Change Disclosures. Proposed section 436.8(c), a new provision, would enhance the current Rule's updating provisions to require franchise sellers to notify prospective franchisees about any material changes that may have occurred since the prospective franchisees received their disclosure documents. For example, it is possible that a franchisor may file for bankruptcy, lose a class action suit that might affect its ability to continue in business, or undergo some other material change since the last quarterly update. Currently, franchisors must notify prospective franchisees only about material changes underlying a financial performance representation.[241] To prevent fraud, proposed section 436.8(c) makes clear that it is an omission of material information in violation of section 5 of the FTC Act for a franchisor to fail to alert prospective franchisees about material changes when it knows that prospective franchisees are relying on the incomplete information contained in a disclosure document. Franchise sellers, therefore, must alert prospective franchisees about any material changes since the last quarterly update when they furnish the disclosure document. Franchise sellers must also alert prospective franchisees to any additional material changes when they deliver a copy of the completed franchise agreement at least five days before the franchise agreement is executed. This proposed revision of the Rule's updating requirements does not require franchisors actually to amend their disclosure documents, which might impose unwarranted costs. Rather, a franchisor must simply notify the prospective franchisee about any such material changes. An oral statement or faxed letter, for example, would be sufficient.

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[241] *See* 16 C.F.R. § 436.1(e)(6).

d. Proposed section 436.8(d): Updated Audited Information. Proposed section 436.8(d) retains the Commission's current policy that audited information in a disclosure document need not be re-audited on a quarterly basis. Rather, a franchisor can update its audited disclosures by including unaudited information, provided the franchisor discloses that the information is unaudited. This instruction is identical to the current Rule updating requirement set forth at 16 C.F.R. § 436.1(a)(22).

12. Proposed section 436.9: Exemptions

The Commission proposes to retain all of the existing Rule exemptions and to add several additional exemptions. At the same time, the Commission proposes to eliminate the exclusions currently found at 16 C.F.R. §§ 436.2(a)(4)(i)-(iv).[242] In the SBP, the Commission recognized that these four relationships are *not* franchises, but might be perceived as falling within the definition of a franchise.[243] To avoid any confusion, the Commission expressly excluded these four relationships from Rule coverage. The Commission believes that these exclusions no longer serve a useful purpose. While there may have been some confusion about the extent of Rule coverage at the time the Commission promulgated the Franchise Rule nearly twenty years ago, the Commission does not believe that such confusion exists today. Since the Rule went into effect in the 1970s, the franchise community has become very familiar with the Rule's requirements, including the definition of the term franchise. In eliminating the four exemptions, however, the Commission is not signaling a substantive change in Commission policy. Rather, the elimination of the exclusions is simply part of the Commission's general effort to streamline the Rule.

a. Proposed section 436.9(a): Minimum Payment Exemption. Proposed section 436.9(a) is substantially similar to the Commission's current $500 minimum investment exemption found at 16 C.F.R. § 436.2(a)(3)(iii). This exemption ensures that the Rule "focuses upon those franchisees who have made a personally significant monetary investment and who cannot extricate themselves from the unsatisfactory relationship without suffering a financial setback."[244] Proposed section 436.9(a) also enhances the current minimum payment exemption by incorporating the Commission's long-standing policy exemption for inventory purchases into an express Rule exemption. In the Final Interpretive Guides, the Commission stated that, as a matter of policy, it would exempt from the Rule's "required payment" definitional element

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[242] The Rule currently excludes four non-franchise relationships: (1) employer-employee and general partnership relationships; (2) relationships created by membership in a cooperative association; (3) relationships in a testing or certification service; and (4) "single" license relationships.

[243] SBP, 43 FR at 59708.

[244] SBP, 43 FR at 59704.

reasonable amounts of inventory purchased at bona fide wholesale prices for resale.[245] In adopting this policy, the Commission recognized that it is often difficult to distinguish between inventory purchases that are required by contract or by practical necessity and those that are merely discretionary. The Commission noted, however, that franchisors could disguise up-front franchisee fees by inflating the level of inventory franchisees must purchase and/or inflating the purchase price. To reduce this fear, the Commission limited the policy exemption to reasonable amounts of inventory (as determined by standard industry practices) and purchases at bona fide wholesale prices.[246] The proposed exemption, therefore, does not change Commission policy, but makes it clear that traditionally non-franchised businesses can sell inventory without the fear of triggering the Rule's minimum payment requirement.

b. Proposed section 436.9(b): Fractional Franchise Exemption. Proposed section 436.9(b) retains the fractional franchise exemption currently found at 16 C.F.R. § 436.2(a)(3)(i). However, the definition of the term "fractional franchise" has been modified slightly, as discussed above at Section C.4.f.

c. Proposed section 436.9(c): Leased Department Exemption. Proposed section 436.9(c) retains the leased department exemption currently found at 16 C.F.R. § 436.2(a)(3)(ii). However, the Commission has streamlined the exemption by creating a clearer and shorter definition of the term "leased department," as discussed above at Section C.4.m.

d. Proposed section 436.9(d): Petroleum Marketers and Resellers Exemption. Proposed section 436.9(d) adds a new exemption for petroleum marketers and resellers covered by the Petroleum Marketing Practices Act ("PMPA"). 15 U.S.C. § 2801. In 1980, the Commission granted a petition for an exemption from the Rule filed by several oil companies and oil jobbers, pursuant to section 18(g) of the FTC Act.[247] Specifically, the Commission stated that the Rule "shall not apply to the advertising, sale or other promotion of a 'franchise,' as the term 'franchise' is defined by the [PMPA]."[248] In considering the petition, the Commission noted that the most frequently cited complaint voiced in the record about the petroleum franchise industry concerned termination and renewal practices. After the close of the Commission's franchise rulemaking record, Congress passed the PMPA, which specifically addressed that complaint, requiring, among other things, pre-sale disclosure of franchisees' termination and renewal rights. Accordingly, the Commission concluded that the Franchise Rule was largely duplicative of the PMPA and related federal regulations.

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[245] Final Interpretive Guides, 44 FR at 49967.

[246] *Id.*

[247] *See* 45 FR 51765 (August 5, 1980).

[248] *Id.* at 51766.

Since 1980, Commission staff has received only isolated complaints regarding abuses in the relationship between petroleum franchisors and their franchisees, and the Commission has no reason to believe that a pattern of abuse is likely to develop in the near future. Moreover, even if such abuses did occur, the Commission has already committed itself to handling the matter through an industry-specific rulemaking.[249] For these reasons, the Commission proposes to incorporate the 1980 policy exemption into the Rule as an express Rule exemption.

e. Proposed section 436.9(e): Sophisticated Investor Exemptions. Proposed section 436.9(e) sets forth two new exemptions, which collectively can be referred to as "sophisticated investor" exemptions: (1) the large investment exemption; and (2) the large corporate franchisee exemption. In response to the ANPR, several commenters urge the Commission to adopt a sophisticated investor exemption to the Rule.[250] These commenters note that franchising today may involve heavily-negotiated, multi-million dollar deals between franchisors and highly sophisticated individual and corporate franchisees who are represented by counsel. In the course of such deals, the franchisees often demand and receive information from the franchisor that equals or exceeds the disclosures required by the Rule. They contend that these are not the kinds of franchise sales that the Rule was intended to cover. Commenters further assert that the Rule's mandatory waiting requirements (currently 10 business days to review disclosures and five business days to review completed contracts) impose unnecessary costs and add unwarranted delay in the high-paced negotiation process, where parties often are anxious to cement their deals quickly to beat out the competition.[251] At the same time, some commenters voice concern about the breath of any such exemption. They fear that investors may appear to be sophisticated only

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[249] At the time the Commission granted the petition, it recognized that circumstances may change in the industry which would warrant a fresh review:

> [I]f circumstances change in the future and evidence of renewed misrepresentations in the sale of petroleum franchises reappears on a significant scale, a new rulemaking proceeding may be undertaken that is tailored to the specific needs of the industry. In the interim, if isolated abuses occur, they will be subject to the adjudicative procedures and remedies provided by Section 5 of the FTC Act.

Id.

[250] *See* Tifford, Comment 78, at 2; Duvall & Mandel, Comment 114, at 2-3; Cendant, Comment 140, at 2; Kaufmann, 18Sept97 Tr at 190; Wieczorek, *id.* at 192; Forseth, *id.* at 194-95. *See also* Caruso, Comment 118, at 1. Some commenters did not advance a sophisticated investor exemption, but did not oppose it. *See* Bundy, 6Nov97 Tr at 19-20.

[251] *See* Kaufmann, 18Sept97 Tr at 165, 170-71; Wieczorek, *id.* at 187-88 and 6Nov97 Tr at 26. One Commenter notes that while franchisors can file individual petitions for exemptions to the Rule under section 18(g), the process is costly and the delay involved often renders this approach an unviable option. Duvall & Mandel, Comment 114, at 16.

because of a certain net worth or prior business experience, but may have limited knowledge of the risks inherent in operating the specific franchise being offered. In short, they contend that the Commission should protect the wealthy, but inexperienced.[252]

Based upon the record, the Commission agrees that appropriate exemptions for sophisticated investors are warranted. The Commission has long recognized that the Rule's protections may be unnecessary where the likelihood of abuse does not exist. Proposed section 436.9(e)(1) would exempt franchise sales where the investment totals at least $1.5 million. The Commission believes that one measure of "sophistication" is the size of the investment. In granting petitions for exemption from the Franchise Rule under section 18(g) of the FTC Act, the Commission has noted several factors that, when present, suggest that application of the Rule may be unwarranted, including the size of the investment. For example, in granting the Petition submitted by the Automobile Importers of America, Inc.,[253] the Commission observed:

> Prospective motor vehicle dealers make extraordinarily large investments. As a practical matter, investments of this size and scope involve relatively knowledgeable investors or the use of independent business advisors, and an extended period of negotiation. The record is consistent with the conclusion that the transactions negotiated by such knowledgeable investors over time and with the aid of business advisors produce the pre-sale information disclosure necessary to ensure that investment decisions are the product of an informed assessment of the potential risks and benefits of the proposed investment.

Id. at 51,764.

The Commission believes that a $1.5 million threshold is sufficient to exempt sophisticated investors, yet protect ordinary consumers who seek to purchase a franchise. Consumers who have $1.5 million available to invest in a franchise are likely to be experienced business persons.[254] Further, an investment of $1.5 million most likely would involve the purchase of a single large investment -- such as a hotel or the most expensive restaurant location -- or the purchase of multiple, less costly units. Purchasers of multiple units are more likely to be persons with significant business experience in light of the management demands such as hiring staff and ensuring efficient operation of the outlets. In addition, purchasers of multiple units are likely to include existing franchisees with significant prior experience with the franchisor. These experienced investors are not likely to purchase a franchise on impulse, are more likely to

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[252] *See* Zarco & Pardo, Comment 134, at 4-5; Kezios, 6Nov97 Tr at 47-48; Bundy, *id*, at 48-49.

[253] 45 FR 51763 (August 5, 1980).

[254] *See* Wieczorek, 6Nov97 Tr at 43.

negotiate over the terms of any contract, and are more resistant to high pressure sales representations.

Proposed section 436.9(e)(1) has additional safeguards beyond the $1.5 million threshold to ensure that average consumers will be protected. First, the proposed exemption makes clear that funds obtained from the franchisor (or an affiliate) cannot be counted toward the $1.5 million threshold. Most purchasers of a franchise, or group of franchises, that require a $1.5 million level of investment will have to turn to banks or other sources of financing. Lenders most likely will ensure that the investor has conducted a due diligence investigation of the offering before approving any loan.[255] This assurance, however, is absent if the source of any funds is the franchisor or an affiliate. Indeed, a prospective franchisee who is inclined to purchase without a thorough examination of the proposed franchise deal may also be lulled into making a large investment when offered attractive financing by the franchisor.

Second, the proposed large investment exemption requires the prospective franchisee to sign an acknowledgment that the franchise sale is exempt from the Franchise Rule because the prospective franchisee will be investing more than $1.5 million. This requirement will reduce the probability that the franchisor may misrepresent the cost of the franchise. It will also provide a paper trail in the event an enforcement action becomes necessary.

While the Commission believes that the proposed large investment exemption is proper, it nonetheless solicits additional comment on this issue. Specifically, the Commission seeks comment on whether the proposed $1.5 million threshold is too high or low and, if so, what would be an alternative threshold, including any specific facts or data that would support such an alternative.

Proposed section 436.9(e)(2) would exempt from the Rule the sale of franchises to large corporations, namely those that have been in business for at least five years that have a net worth of at least $ 5 million.[256] There appears to be little risk for abuse where a franchisor sells a single or multiple franchises to a large corporate franchisee. Such transactions often are heavily

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[255] Lenders are also likely to require the prospective investor to have sufficient equity capital in order to qualify for a loan. Indeed, with an investment of $1.5 million, a lending institution may require equity of several hundred-thousand dollars before considering a loan. This lending-industry requirement further ensures that, as a practical matter, the proposed exemption would be limited to sophisticated investors only.

[256] No state has a comparable exemption. Several states -- including California, Indiana, Maryland, New York, North Dakota, Rhode Island, South Dakota, and Washington -- have an exemption from registration for "experienced franchisors," focusing on the franchisor, rather than on the prospective investor. To qualify for the exemption, a franchisor must typically have a net worth of at least $5 million and have had 25 franchise locations in operation during the previous five years. *See generally* Duvall & Mandel, Comment 114, at 3-4.

negotiated by sophisticated counsel who have significant experience in the franchise industry. Even if a large corporation does not have prior experience in franchising specifically, it is reasonable to assume that it can protect its own interests when negotiating for the purchase of a franchise.[257] Nonetheless, the Commission solicits additional comment on the proposed large corporation exemption. Specifically, the Commission seeks comment on whether the proposed 5 years and $5 million thresholds are sufficient and solicits any alternatives.

Finally, proposed section 436.9(e) states that the Commission may publish revised thresholds for the sophisticated investor exemption once every four years to adjust for inflation. While the Commission believes that the proposed thresholds are sufficient today, it is quite possible that in a few years these thresholds will be too low because of inflation. Accordingly, the Commission proposes to publish revised thresholds in the *Federal Register* once every four years.[258] A four-year adjustment period appears to strike the right balance between ensuring that the thresholds keep up with inflation and relieving the Commission of the expense and burden of more frequent adjustments. Nonetheless, the Commission solicits comment on whether a periodic inflation adjustment is warranted, the costs and benefits of a four-year adjustment period, as well as any alternatives.

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[257] *See* Kaufmann, 18Sept97 Tr at 190. The proposed large corporate-franchisee exemption is also a logical extension of the Rule's fractional franchise exemption. The fractional franchisee exemption focuses narrowly on purchasers who wish to expand their product lines, have experience in the field, and face a minimal financial risk. For example, a small grocery store owner probably would be a fractional franchisee if he or she became a snack food distributor. Under the current Rule, however, a hospital purchasing the same snack food distributorship probably would not be deemed a fractional franchisee because of a lack of prior experience in food sales. This is an illogical result, given the hospital's greater financial resources and bargaining power. Hospitals and other large institutions such as airports and universities are hardly the type of "consumers" that the Commission needs to protect. See Kirsch, 18Sept97 Tr at 198-99. *But see* Kezios, *id.* at 191-92.

[258] This inflation adjustment proposal is modeled after the Appliance Labeling Rule, 16 C.F.R. 305, which sets forth ranges of estimated annual energy costs and consumption for various appliances. Because energy cost and appliance efficiencies fluctuate, the Commission adjusts the label requirements periodically by publishing in the *Federal Register* new costs and ranges, which then become part of the rule's labeling requirements. To that end, section 305.9(b) of the Appliance Labeling Rule provides: "Table 1, above, will be revised on the basis of future information provided by the Secretary of the Department of Energy, but not more often than annually." The proposal is also consistent with the Commission's procedures for adjusting thresholds or other information in Commission-enforced statutes. For example, the Commission publishes in the *Federal Register* annual adjustments for determining illegal interlocking directorates in connection with section 19(a)(5) of the Clayton Act, as well as adjustments to civil penalties at least once every four years under the Debt Collection Improvement Act of 1966. *See* 61 FR 54549 (October 21, 1996).

f. Proposed section 436.9(f): Officers and Owners Exemption. Proposed section 436.9(f) would exempt sales to franchisees who are (or recently have been) officers or owners of the franchisor.[259] There does not appear to be any need for disclosure in such circumstances because we can reasonably assume that the prospective franchisee already is familiar with every aspect of the franchise system and the associated risks. Further, in some instances, a company may wish to offer units to its owners or directors only. If not exempt, these companies would have to go through the burden and expense of creating a disclosure document for isolated sales to company insiders. To ensure that individuals qualifying for the exemption have recent and sufficient experience with the franchisor, the proposed exemption is limited to individuals who have been associated with the franchisor within 60 days of the sale and who have been within the franchise system for at least two years.

g. Proposed section 436.9(g): Oral Contracts. The final exemption, proposed section 436.9(g), retains the current exemption for oral contracts found at 16 C.F.R. § 436.2(a)(3)(iv). In the SBP, the Commission recognized that problems of proof make it difficult to regulate purely oral agreements. In addition, the record indicated that oral arrangements are usually informal and require only nominal investments.[260]

13. Proposed section 436.10: Additional Prohibitions

The next section of the Proposed Rule -- proposed section 436.10 -- sets forth additional prohibitions. Proposed section 436.10 differs from the current Rule prohibitions in several respects. First, it updates the Rule's provisions regarding financial performance representations made in the general media to include representations on the Internet and other advertising vehicles. Second, it prohibits franchisors from including integration clauses in their contracts that would effectively absolve them from liability for statements made in their disclosure documents. Finally, it makes clear that the use of paid references (shills) is an unfair and deceptive act or practice in violation of section 5 of the FTC Act.

a. Proposed section 436.10(a): No Contradictory Statements. Proposed section 436.10(a) prohibits franchisors from making any statements that are contradictory to those set forth in their disclosure documents. Except for minor editing, this is identical to the current Rule prohibition set out at 16 C.F.R. § 436.1(f).

b. Proposed section 436.10(b): Refunds. Proposed section 436.10(b) prohibits franchisors from failing to honor their refund guarantees. This is similar to the comparable Rule provision found at 16 C.F.R. § 436.1(h). However, the Commission proposes to modify the

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[259] The proposed exemption is modeled after nearly identical language in California's franchise statute. Washington and Rhode Island have similar exemptions. *See* Duvall & Mandel, Comment 114, at 21.

[260] SBP, 43 FR at 59708.

prohibition slightly. The current section 436.1(h) prohibits franchisors from failing "to return any funds or deposits in accordance with any conditions disclosed pursuant to paragraph (a)(7) of this section." Thus, the provision is limited to instances where the franchisor makes an express refund promise in the disclosure document itself. The Commission's law enforcement experience indicates, however, that in some instances franchisors do not make any specific promise in the disclosure document, but do so either in the franchise agreement or in a separate contract or letter of understanding. Proposed section 436.10(b) makes clear that the failure to honor any written refund promise in connection with a franchise sale will constitute a Rule violation.[261]

c. Proposed section 436.10(c): Written Substantiation. Proposed section 436.10(c) prohibits franchisors from failing to make available to prospective franchisees and to the Commission upon reasonable request written substantiation for any financial performance representations made in an Item 19 disclosure. Except for minor editing, this provision is identical to the current Rule provision found at 16 C.F.R. §§ 436.1(b) and 436.(1)(c).

d. Proposed section 436.10(d): Financial Performance Statements. Proposed section 436.10(d) addresses the dissemination of financial performance representations outside of a disclosure document, including the general media, Internet advertising, and unsolicited commercial E-Mail. In the ANPR, the Commission questioned the continuing need for the general media claims provision currently set out at 16 C.F.R. § 436.1(e).[262] In response, no commenter raised any concerns about the Rule's existing approach toward general media financial performance claims. On the other hand, a few commenters note the proliferation of financial performance claims in the general media. For example, the AFA states:

> You have to look no further than last Thursday's edition of the *Wall Street Journal* to see examples of misleading advertisements with regard to earnings potential. For example, one franchisor consistently advertises by saying "60% to 80% gross profit margins." An advertisement for a master franchisee states "a proven method of making a fortune." . . . Consumers see the advertisement first, the franchise agreement second and then the franchisor's salesperson says something like "we are prohibited by law from making any earnings claims." But the damage has already been done -- the consumer has seen the ad.

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[261] One commenter, Dady & Garner, suggests that franchisees should always receive a refund (minus actual costs) if they never actually open or operate an outlet. Dady & Garner, Comment 127, at 4. The Commission believes that the substantive terms and conditions of refunds are a matter of contract between the parties. As long as the terms and conditions of any refund policy are spelled out in the disclosure document or franchise agreement, that appears to be sufficient.

[262] 62 FR at 9122.

AFA, Comment 62, at 6.[263]

Based upon the record, the Commission believes that disclosure requirements for financial performance representations made in the general media continue to serve a useful purpose. The Commission's law enforcement experience also demonstrates that such claims are prevalent and continue to attract a number of consumers.[264] Indeed, the communications age has ushered in new advertising media such as the Internet and unsolicited commercial E-mail. For example, many companies have home pages that contain express financial performance representations and thousands of consumers receive "spam" E-mail messages encouraging them to invest in various opportunities.[265] Accordingly, guidance concerning financial performance representations in traditional and new advertising media is clearly warranted.

Proposed section 436.10(d) prohibits any franchise seller from making a financial performance representation outside of a disclosure document unless the seller: (1) has a reasonable basis for the claim; (2) has written substantiation for the claim at the time it is made; (3) includes the representation in Item 19 of its disclosure document; (4) includes the number and percentage of the measured outlets that support the claim from its Item 19 disclosure; and (5) includes a conspicuous admonition that a new franchisee's individual financial results may differ from those stated in the representation. In short, a franchisor may make a financial performance claim in advertising materials only if the claim is consistent with, and includes the limited required information taken from, its Item 19 disclosures made to prospective franchisees.

The Commission finds that the proposed section 436.10(d) approach to financial performance claims greatly streamlines the current Rule provision and should make it easier for franchisors to disseminate truthful financial performance information. For example, under the current Rule approach, franchisors making general media performance representations are required to give a prospective franchisee a separate earnings claim document that sets forth the claim in detail and, depending upon the nature of the claim, specific cautionary language. Proposed section 436.10(d) would eliminate these requirements. The Commission believes that

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[263] *See also* Winslow, Comment 92, 1-2.

[264] For example, the Commission's 1995 Project Telesweep, in which the FTC and state law and local enforcement authorities filed nearly 100 law enforcement actions, was based upon the finding that many franchise and business opportunity sellers seek to attract consumers through advertisements, in particular advertisements with outrageous earnings representations.

[265] Indeed, the Commission has testified before the Senate Commerce, Science and Transportation Committee that "the proliferation of deceptive, unsolicited commercial E-mail . . . could undermine consumer confidence and slow the growth of Internet commerce," noting that the FTC has collected over 100,000 pieces of unsolicited commercial E-mail and receives up to 1,500 new pieces daily. *See* FTC News, Growth of Deceptive "Spam" Could Undermine Consumer Confidence in Internet (June 17, 1998).

the Item 19 disclosure requirements, in the format described above, are sufficient to provide meaningful performance information to prospective franchisees without the need for a separate disclosure document.

e. Proposed section 436.10(e): Disclaimers. Proposed section 436.10(e), a new prohibition, addresses the issue of contract integration clauses. It would prohibit franchisors from disclaiming liability for, or causing franchisees to waive reliance on, statements made in their disclosure documents. In response to the ANPR, a number of franchisees and their representatives commented that franchisors routinely seek to disclaim liability for their pre-sale disclosures through the use of contract integration clauses. These clauses effectively force franchisees to waive any rights they have to rely on pre-sale disclosures made to them during the sales process. For example, one commenter states:

> In virtually every lawsuit I have filed for franchisees alleging fraud, franchise disclosure, or unfair or deceptive practices (under California law since the FTC rule does not provide a private right of action), counsel for the franchisor defendants have defended the action on lack of justified reliance. Franchisors and their counsel have systemically written the agreements to strip franchisees of all fraud claims and rights the minute the agreement is signed by sophisticated integration, no representation and no reliance clauses. . . . The Commission should provide that reliance on the disclosure document and other representations made in the sale of a franchise is per se justified.[266]

Lagarias, Comment 125, at 4.

Another commenter adds that integration clauses are not well understood and their impact is not appreciated at all until long after the franchise purchasing commitment is made.[267]

Based upon the record, the Commission does not recommend banning the use of integration clauses as a deceptive or unfair act or practice. Integration clauses can serve a useful purpose, ensuring that prospective franchisees rely only on information authorized by the franchisor or within the franchisor's control. For example, a franchisor reasonably may seek to disclaim liability for unauthorized claims made by rogue salespersons, statements made by former or current franchisees, or even unattributed statements found in the trade press. The Commission, however, believes it is a violation of section 5 for franchisors to use integration clauses essentially to shield themselves from liability for false or deceptive statements made in their disclosure documents. The Commission has long recognized that the integrity of a

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[266] *See also* Manuszak, Comment 13, at 1; Bell, Comment 30, at 1; Sibent, Comment 41, at 1 (and 19 identical comments); AFA, Comment 62, at 3; Bundy, Comment 119, at 2; Selden, Comment 133, Appendix B, at 2; Zarco & Pardo, Comment 134, at 3.

[267] Selden, Comment 133, Appendix B, at 2.

franchisor's disclosure document is critical to prospective franchisees. For that reason, disclosures must be complete, accurate, legible, and current. The Rule also prohibits franchisors from making any statements that contradict those in a disclosure document. The use of integration clauses to disclaim liability for required disclosures undermines the very purpose of the Rule, which is to prevent fraud and abuse by ensuring that prospective franchisees have complete, truthful, material information with which to make a sound investment decision.[268] Accordingly, proposed section 436.10(e) will better ensure that prospective franchisees will receive complete and truthful pre-sale disclosures.

At the same time, the Commission recognizes that a prohibition on disclaimers or waivers may have the unintended effect of chilling the parties' willingness to negotiate freely franchise contract terms. A franchisor may interpret an anti-disclaimer prohibition to mean that it is bound by the terms and conditions set forth in a disclosure document only and that any modification will constitute a Rule violation. To rectify this potential misinterpretation, proposed section 436.10(e) specifically provides that a prospective franchisee can agree to terms and conditions that differ from those specified in a disclosure document if: (1) the franchise seller identifies the changes; (2) the prospective franchisee initials the changes in the franchise agreement; and (3) the prospective franchisee has five days to review the completed revised contract before the sale is consummated, consistent with proposed section 436.2(a)(2) described above.

f. Proposed section 436.10(f): Shills. Proposed section 436.10(f) adds a prohibition against franchisors' use of phony references or "shills." Proposed section 436.10(f) would make it a Rule violation for a franchisor to misrepresent that any person has actually purchased or operated one of the franchisor's franchises. It also would make it a Rule violation for a franchisor to misrepresent that any person can give an independent and reliable report about the experience of any current or former franchisee. The Commission's law enforcement experience demonstrates that, in many instances, scam artists use shill references in order to bolster their

[268] Integration clauses effectively require franchisees to waive reliance on statements made in the disclosure document. The Commission has long disfavored the waiver of rights afforded by Commission trade regulation rules. *See* Used Car Rule, 16 C.F.R. 455 at § 455.3(b); Credit Practices Rule, 16 C.F.R. 444 at § 444.2; Cooling-Off Period Rule, 16 C.F.R. 429 at § 429.1(d); and Ophthalmic Practices Rule, 16 C.F.R. 456 at § 456.2(d).

earnings and success claims.[269] Indeed, shills are often the glue that holds the scam together by allaying consumers' concerns about the investment.[270]

14. Proposed section 436.11: Other Laws, Rules, and Orders

Proposed section 436.11 addresses the effect the revised Rule may have on other Commission laws and outstanding Commission orders. It also discusses preemption of state franchise laws that may be inconsistent with this Rule.

a. Proposed section 436.11(a): Effect on Other Commission Laws. Proposed section 436.11(a) makes clear that the Commission does not express any opinion about the legality of any practices that might be disclosed in a franchisor's disclosure document. The current Rule contains a comparable provision at note 1 at the end of the Rule. In the SBP, the Commission recognized that some of the Rule's provisions may require franchisors to disclose practices that may raise antitrust issues.[271] The provision makes clear that the Commission reserves the right to pursue violations of antitrust laws even if a franchisor discloses the violation in complying with the Rule's disclosure requirements. In short, disclosure does not create a safe harbor for franchisors engaging in otherwise unlawful conduct. At the same time, proposed section 436.11(a) clarifies that compliance with the Rule's specific disclosure requirements will not shield a franchisor from the broader anti-deception provision of section 5 of the FTC Act.[272] The Commission finds that this clarification is critical especially in an age of quickly developing technologies. The Commission cannot now predict what information about the franchise relationship will be material in the future, in particular franchisors' and franchisees' rights and obligations concerning issues such as the use of Internet home-pages, electronic advertising, and

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[269] *E.g., FTC v. Hart Mktg. Enter., Inc.,* No. 98-222-CIV-T-23 E (M.D. Fla. 1988); *FTC v. Stillwater Vending, Ltd.,* No. 97-386-JD (D.N.H. 1997); *FTC v. Unitel Sys., Inc.,* No. 3-97CV1878-D (N.D.Tex. 1997); *FTC v. Southeast Necessities Co., Inc.,* No. 6848-CIV-Hurley (S.D. Fla. 1994); *Car Checkers of America,* Bus. Franchise Guide (CCH) ¶ 10,163, at 24,042. Indeed, in two actions, the Commission named a shill in its complaint, charging each with violating section 5 of the FTC Act. *See FTC v. Vendors Fin. Serv., Inc.*, No. 98-N-1832 (D. Colo. 1998); *FTC v. Urso*, Bus. Franchise Guide (CCH) ¶ 11,410 (S.D. Fla. 1997). *Cf. O'Rourke*, Bus. Franchise Guide (CCH) ¶ 10,243 (evidence of shills admitted at contested Preliminary Injunction hearing).

[270] NCL reports that complaints about fake references are among the most common franchisee and business opportunity complaints it receives. NCL, Comment 35, at 2.

[271] SBP, 43 FR at 59719.

[272] *See, e.g., FTC v. Hart Mktg. Enter. Ltd., Inc*., No. 98-222-CIV-T-23 E (M.D. Fla. 1998); *FTC v. Inetintl.com*, No. 98-2140 (C.D. Cal. 1998); *FTC v. Maher*, No. WMN-98-495 (D.Md. 1998); *FTC v. Nat'l Consulting Group, Inc*., No. 98 C 0144 (N.D. Ill. 1998).

electronic commerce. Franchisors' disclosure obligations under section 5 must remain somewhat flexible to ensure that franchisors continue to provide prospective franchisees with all material information as new technologies and marketing practices emerge.

b. Proposed section 436.11(b): Effect on Prior Commission Orders. Since the Rule went into effect in the 1970s, the Commission has brought over 150 franchise and business opportunity cases. The Commission recognizes that it is possible that the revised Rule may impose disclosure or other obligations that are inconsistent with the terms of existing Commission orders. To reduce any potential conflicts between existing orders and provisions of the revised Rule, proposed section 436.11(b) would permit firms under order to petition the Commission for relief consistent with the provisions of the revised Rule.

c. Proposed section 436.11(c): Preemption. Proposed section 436.11(c) retains the preemption provision currently found at note 2 at the end of the Rule.[273] It provides that the Commission does not intend to preempt state or local franchise practices laws, except to the extent of any inconsistency with the Rule. It provides further that a law is not inconsistent if it affords prospective franchisees equal or greater protection, such as registration of disclosure documents or more extensive disclosures.

d. Proposed section 436.12: Severability. Proposed section 436.12 retains the severability provision currently found at 16 C.F.R. § 436.3. This provision makes clear that, if any part of the rule is held invalid by a court, the remainder will still be in effect.[274]

Section D -- Rulemaking Procedures

Pursuant to 16 C.F.R. § 1.20, the Commission has determined to use the following rulemaking procedures. These procedures are a modified version of the rulemaking procedures specified in section 1.13 of the Commission's Rules of Practice.

First, the Commission intends to publish a single Notice of Proposed Rulemaking. The

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[273] *See* 16 C.F.R. 436, note 2. This approach is consistent with other Commission trade regulation rules. *See, e.g.,* Appliance Labeling Rule, 16 C.F.R. 305 at § 305.17; Cooling-Off Rule, 16 C.F.R. 429 at § 429.2; Mail Order Rule, 16 C.F.R. 435 at § 435.3(b)(2); R-Value Rule, 16 C.F.R. 460 at § 460.23.

[274] This provision is comparable to the severability provisions in other Commission trade regulation rules. *See, e.g.,* 900-Number Rule, 16 C.F.R. § 308.8; Telemarketing Sales Rule, 16 C.F.R. § 310.8.

comment period will be open for 60 days, followed by a 40-day rebuttal period. Second, pursuant to section 18(c) of the Federal Trade Commission Act,[275] the Commission will hold hearings with cross-examination and rebuttal submissions only if an interested party requests a hearing by the close of the comment period. Parties interested in a hearing must also submit within the comment period the following: (1) a comment on the NPR; (2) questions of fact in dispute; and (3) a summary of the expected testimony. Parties wishing to cross-examine witnesses must also file a request by the close of the comment period. If requested to do so, the Commission may also consider holding one or more informal public workshop conferences in lieu of hearings. After the close of the comment period, the Commission will publish a notice in the Federal Register stating whether hearings (or a public workshop conference in lieu of hearings) will be held and, if so, the time and place of the hearings and instructions for those wishing to present testimony or engage in cross-examination of witnesses.

Finally, after the conclusion of the rebuttal period, and any hearings or additional public workshop conferences, Commission staff will issue a Report on the Franchise Rule ("Staff Report"). The Commission will announce in the Federal Register the availability of the Staff Report and will accept comment on the Staff Report for a period of 60 days.

Section E -- Communications to Commissioners and Commissioner Advisors by Outside Parties

Pursuant to Commission Rule 1.18(c)(1), the Commission has determined that communications with respect to the merits of this proceeding from any outside party to any Commissioner or Commissioner advisor shall be subject to the following treatment. Written communications and summaries or transcripts of oral communications shall be placed on the rulemaking record if the communication is received before the end of the comment period on the staff report. They shall be placed on the public record if the communication is received later. Unless the outside party making an oral communication is a member of Congress, such communications are permitted only if advance notice is published in the *Weekly Calendar and Notice of "Sunshine" Meetings.*[276]

Section F -- Regulatory Analysis and Regulatory Flexibility Act Requirements

Section 22 of the FTC Act, 15 U.S.C. 57b, requires the Commission to issue a preliminary regulatory analysis for a rule amendment proceeding if it: (1) estimates that the amendment will have an annual effect on the national economy of $100,000,000 or more; (2) estimates that the amendment will cause a substantial change in the cost or price of certain categories of goods or services; or (3) otherwise determines that the amendment will have a significant effect upon covered entities or upon consumers. Based upon the record, the

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[275] 15 U.S.C. 57a(c).

[276] *See* 15 U.S.C. § 57a(i)(2)(A); 45 FR 50814 (1980); 45 FR 78626 (1980).

Commission has preliminarily determined that the proposed amendments to the Rule will not have such an effect on the national economy, on the cost or prices of franchised goods or services, or on covered businesses or consumers. To ensure that the Commission has considered all relevant facts, however, it requests additional comment on this issue.

The Regulatory Flexibility Act ("RFA"), 5 U.S.C. 601 *et seq*., requires an agency to conduct an analysis of the anticipated economic impact of proposed rule amendments on small businesses.[277] The purpose of a regulatory flexibility analysis is to ensure that the agency considers the impact on small entities and examines regulatory alternatives that could achieve the regulatory goals while minimizing burdens on small entities. The RFA does not apply if the agency head certifies that the regulatory action will not have a significant economic impact on a substantial number of small entities. As discussed below, the Commission believes that the proposed Rule amendments will not have a significant economic impact upon small businesses subject to the Rule. Accordingly, the Commission certifies that the RFA does not apply to the proposed Franchise Rule amendments.

The proposed Rule amendments affect pre-sale disclosure for the sale of franchises, and thus are likely to have an impact on all franchisors, some of which are small entities. Determining the precise number of small entities affected by these proposed amendments, however, is difficult due to the wide range of industries involved in franchising. The Commission estimates that there are approximately 5,000 franchisors selling franchises in the United States, including 2,500 business format and product franchisors and 2,500 business opportunity sellers. Most business opportunities and some established and start-up franchise systems would likely be considered small businesses according to the applicable SBA size standards. As a result, the Commission estimates that as many as 70% of franchisors, as defined by the Rule, are small entities.

Nonetheless, the proposed amendments do not appear to have a significant economic impact upon such entities. For the most part, the Commission's proposed amendments, as detailed throughout this notice, streamline and reorganize the Rule's disclosures based upon the UFOC Guidelines model. The Rule's revised disclosure requirements, therefore, would be more closely aligned with the UFOC format, which is considered by many to be the national franchise disclosure standard.[278] Other proposals seek to clarify and refine the Rule, for instance, by

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[277] The RFA addresses the impact of rules on "small entities," defined as "small businesses," "small governmental entities," and "small [not-for-profit] organizations." 5 U.S.C. 601. The Franchise Rule applies only to the first type of entity.

[278] *See supra* at Section C.2.

providing new or revised definitions. Accordingly, we would expect the vast majority of franchisors to incur only minor costs in adapting to the proposed revised Rule.[279]

Further, in a few instances, the proposed amendments will reduce franchisors' compliance costs. For example:

(1) Proposed section 436.2. This provision limits the scope of the Rule to franchise sales in the United States, potentially relieving franchisors of substantial costs associated with preparing disclosure documents for international sales. Because franchisors selling internationally are generally large franchisors, we do not expect this proposal to have a significant effect on small entities.

(2) Proposed section 436.9(e). This provision sets forth new exemptions for sophisticated investors. These proposals similarly will reduce costs to those franchisors that are not likely to engage in fraudulent franchise sales. Since the proposed exemptions, by their terms, apply only to large investments, or investments made by very large companies, we would expect little if any impact on small entities.

(3) Proposed section 436.7. This provision expressly permits franchisors to utilize the Internet and other electronic media to furnish disclosure documents. Allowing this distribution method could greatly reduce franchisors' compliance costs over the long run, especially costs associated with printing and distributing disclosure documents. As a result of this proposal, we expect franchisors' compliance costs will decrease over time, but do not expect the immediate impact to be substantial for most franchisors, in particular smaller franchise systems.

A few proposed Rule amendments, however, may increase franchisors' compliance costs. Nonetheless, the Commission expects these costs to be *de minimis* and to decline after the franchisors' initial fiscal year of complying with the proposed amended Rule. These proposals require franchisors to disclose additional material information that will shed light on the state of the franchise relationship or increase prospective franchisees' ability to conduct their own due diligence investigation of franchise offerings. While these proposals could potentially impact both large and small franchisors, we would expect any impact to be greatest with larger franchise systems. For example,

(1) Proposed section 436.3. This would require franchisors to include in the disclosure document's cover page references to several franchise resources, such as the Commission's Internet web site and its "Consumer Guide to Purchasing a Franchise." These references assist prospective franchisees by notifying them of valuable information that is available on franchising. The provision applies to all franchisors, but at minimal cost.

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[279] The franchisors who do not currently use the UFOC format would, of course, have greater compliance costs associated with adapting to a new format. However, the number of small entities within this subset does not appear to be substantial.

(2) Proposed section 436.5(c). This provision would require franchisors to disclose pending litigation brought by franchisors against their franchisees involving the franchise relationship. Providing this additional information gives prospective franchisees further insight into the relationship between the franchisor and current and former franchisees. While this proposed change would apply to all franchisors, the impact is likely to be greatest on large systems, which by definition, have a significant number of franchisees, and therefore, a greater likelihood of pending litigation against franchisees.

(3) Proposed section 436.5(t)(6). This would require franchisors to make a prescribed statement about the use of "gag clauses," if applicable. This proposed section also includes two additional optional disclosures, whereby franchisors are permitted to disclose the number and percentage of franchisees who have signed gag clauses, and the circumstances under which the gag clauses were signed. The economic impact of including the prescribed statement alone is negligible. Any additional costs will arise from franchisors' voluntarily complying with the Rule's optional provisions. Further, we can expect that larger systems are more likely than small entities to have a significant number of franchisees who have signed gag clause provisions.

(4) Proposed section 436.5(t)(7). This provision would require franchisors to disclose the names and addresses of trademark-specific franchisee associations that request to be included in the franchisors' disclosure document. This information would further assist prospective franchisees in investigating the franchise system, with virtually no change in the cost of preparing a disclosure document. The number of trademark-specific franchisee associations in any single franchise system is likely to be limited, especially in small franchise systems. Further, those associations that wish to be included in the disclosure document must provide the franchisor with all of the relevant information. Thus, including this information in a disclosure document should have very little impact on franchisors' document preparation costs.

For the reasons outlined above, the Commission believes that the proposed Rule amendments, taken as a whole, will likely have a negligible economic impact on franchisors' compliance costs, particularly for small franchisors. Presumably, compliance costs will vary with the size of the franchise system, with smaller franchisors incurring lower costs. The Commission estimates that franchisors will be required to spend between 1 and 5 hours to comply initially with the proposed revised disclosure requirements. At an average hourly billing rate of $250, the estimated cost to each system will be between $250 and $1,250. These amounts are not significant, especially in the context of franchisors' total yearly income and expenses. Further, any initial compliance costs will presumably decrease after the franchisor has revised its disclosures into the new format, and may well be offset by the Rule amendments' streamlined disclosure provisions.

Therefore, based on the available information, the Commission certifies that amending the Franchise Rule will not have a significant economic impact on a substantial number of small businesses. To ensure that no significant economic impact is being overlooked, however, the Commission requests comments on this issue. The Commission also seeks comments on possible alternatives to the proposed amendments to accomplish the stated objectives. After

reviewing any comments received, the Commission will determine whether a final regulatory flexibility analysis is appropriate.

Section G -- Paperwork Reduction Act

In this notice, the Commission proposes to alter some information collections contained in the Franchise Rule. As required by the Paperwork Reduction Act of 1995 ("PRA"), 44 U.S.C. 3507(d), the Commission has submitted a copy of the information collections to the Office of Management and Budget ("OMB") for its review. The current public disclosure and recordkeeping burden for collections of information contained in the Rule is 36,200 hours, approved under OMB Control No. 3084-0107, expiration date March 31, 1999. In that clearance submission, we estimated there were 3,613 franchisors. For the following calculations, we estimate that there are currently 5,000 franchise systems, consisting of 2,500 business format and product franchisors and 2,500 business opportunity sellers. The 1999 estimate of the cost to comply with the collections of information contained in the Rule, which includes both business format and product franchisors and business opportunities, is $19,925,000, and the total burden hours associated with these collections is currently projected to be 33,500.[280] As discussed below, we expect that the proposed Franchise Rule amendments will result in a large information collection savings, resulting primarily from eliminating business opportunities from Rule coverage.

The proposed amendments are designed to improve the Rule's organization and language, while also adding and changing some of the disclosure items. The proposals will impact franchisors differently, and, depending on the particular franchisor, may eliminate completely, reduce, or slightly increase, franchisors' compliance costs and burdens. Some of the more significant proposed amendments address the scope of the Franchise Rule, such as the proposal that separates the disclosure requirements for franchises from those of business opportunities. Other proposals offer new disclosure alternatives or requirements, and may impact franchisors' information collection. These include, for example, giving franchisors the option to use the Internet to furnish disclosure documents, and requiring franchisors to disclose information about known trademark-specific franchisee associations. Still other proposed amendments simply clarify certain existing disclosure requirements and should also provide an overall benefit to affected respondents without increasing costs. These clarifications, however, are not changes to the regulation and accordingly, they do not affect the collections of information contained in the regulation. Where proposals do change an information collection requirement, we discuss them below. Following is a summary of the more important proposed amendments to the Rule:

(1) Eliminating the Rule's Coverage of Business Opportunities. The proposed Rule will no longer apply to business opportunity sellers, who will be covered by a separate Rule. Thus,

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[280] *See* 64 FR 1206 (January 8, 1999), announcing a request for a three year extension of the Franchise Rule's current information collection requirements. In that notice, the burden hour estimate was reduced from 36,200 to 33,500.

compliance costs for business opportunity sellers will drop to zero. In the past, we have estimated that approximately five hours are needed for business opportunities to comply with the information collection requirements contained in the Rule, and 15 hours are needed by franchisors. Eliminating business opportunities from the Rule would therefore result in a total savings of 12,500 labor hours (2,500 business opportunity sellers x 5 hours) and $3.125 million (12,500 hours x $250 per hour), as well as a savings of $3.75 million in printing costs (2,500 business opportunity sellers x $1,500 printing costs per company).

(2) Adopting Three Sophisticated Investor Exemptions. Proposed section 436.9(e) will exempt certain franchise offerings from the Rule's disclosure obligations. This proposal acknowledges that in very large transactions, and in transactions that involve certain owners and managers of the franchise system, the individuals involved have the experience and resources necessary to obtain important information about the franchise system independently. For those companies that qualify, these exemptions could eliminate all disclosure burdens. Assuming that 5 percent of franchise systems, or 125 firms, will be exempted, this will result in a reduction of 1,875 hours and $468,750 (1,875 x $250).

(3) Revising the Rule's Disclosure Requirements Based Upon the UFOC Guidelines Model. Revising the Rule based on the UFOC Guidelines model will benefit affected entities by bringing greater uniformity to franchise disclosure documents. In practice, the UFOC is the national standard. Because the proposed revised Rule format is patterned after the UFOC format, we estimate that franchisors' time and costs needed to comply with the Franchise Rule will be reduced by 1 hour, for a net savings of 2,375 hours and $593,750 (1 hour x $250 per 2,375 companies).

(4) Improving the Rule's Organization and Language. Deleting provisions that no longer serve a useful purpose and streamlining the Rule by adopting, for instance, a clear, bright line disclosure trigger, will make the Rule easier to understand and thus, foster easier compliance. Although the net savings under this proposal attributable to better organization and language are difficult to quantify, we believe that franchisors may save an average of 1 hour in compliance time at $250 per hour, for a net savings of 2,375 hours and $593,750

(5) Permitting Compliance Through the Internet and Other Electronic Media. Proposed section 436.7 could potentially reduce franchisors' compliance costs significantly, especially the costs and hours associated with printing and distributing disclosure documents, which at 6 hours per year, is the bulk of the current hourly burden estimate. Distributing documents electronically would eliminate the 6 hours per year for those franchisors no longer printing and mailing any of their disclosure documents. We approximate that 20 percent of franchisors, or 475 franchisors, will initially make use of this proposal, and each will distribute 50 of their 100 documents electronically, saving three hours per year. This will result in a reduction of 1,425 hours. This provision, however, will also require franchisors to adapt and distribute their electronic and summary documents. We estimate that those 475 franchisors will spend 1 hour to adapt and distribute their electronic and summary documents for an additional burden of 475 hours.

Accordingly, franchisors' use of the electronic disclosure option will result in a net reduction of 950 hours.

Further, we have previously estimated that printing and mailing one disclosure document averages approximately $25.00 ($35 for franchisors and $15 for business opportunity sellers) and that 5,000 franchisors and business opportunity sellers print and distribute 100 copies annually, for a total cost of $12.5 million. We believe that the proposed amendment permitting electronic disclosure would reduce the distribution cost per electronic disclosure document to $5.00, for a total net savings of $712,500 (475 franchisors furnishing 50 electronic disclosure documents each at a saving of $30 per electronic disclosure document). We anticipate that time and costs will further decline in the future as more franchisors make greater use of electronic media.

(6) Disclosing Additional Resources and Information for Franchisees. Proposed section 436.3 requires the disclosure document's cover page to reference the Commission's Internet web site, where consumers can find resources on franchising and related topics. This information will provide significant benefit to consumers, as will requiring the cover page to note the availability of the *Commission's Consumer Guide To Purchasing a Franchise.* Another proposed amendment, proposed section 436.5(a), would require franchisors to disclose information about their predecessors, industry-specific regulations, and the general competition prospective franchisees are likely to face. Finally, proposed 436.5(t)(7) would require a franchisor to disclose the names and addresses of trademark-specific franchisee associations that ask to be listed in the franchisor's disclosure document. These associations can often provide prospects with additional information on the franchise system.

The proposed cover sheet changes would not constitute "collections of information" as that term is defined in the PRA, because the text is being provided by the Government and the PRA exempts any "information that is originally supplied by the Federal government to the recipient for the purpose of disclosure to the public." 5 C.F.R. § 1320.3(c)(2). Requiring disclosure of predecessor information, regulations and competition, while not exempt, would only impose a *de minimis* burden, since presumably, franchisors would already possess this information. Likewise, disclosing information about trademark-specific franchisee associations would also impose only a *de minimis* burden on the affected entities, since franchisors would only be responsible for disclosing information about those associations that request to be included in the disclosure document. We estimate that only one hour per year per franchisor would be needed to comply with these disclosure requirements for a total increase of 2,375 hours and a cost of $593,750.

(7) Disclosing Additional Information About the Franchise Relationship. Proposed section 436.5(c), which requires franchisors to disclose pending lawsuits brought against franchisees, would give potential franchisees information about the types of problems in the franchise system, and the extent to which a franchisor uses litigation to resolve disputes. The Rule currently requires the disclosure of litigation brought by franchisees against franchisors and this has not proven to be overly burdensome. Disclosing additional lawsuits would also generally be *de minimis*, since this information is well-known by the franchisor, is usually

already compiled during the ordinary course of business, and can easily be updated at the beginning and end of a lawsuit. Accordingly, we have assigned 1 hour to this task for a total of 2,375 hours and a cost of $593,750.

(8) Requiring Disclosure About Gag Clauses. Proposed section 436.5(t)(6) includes a new provision that requires franchisors to disclose their use of gag clauses. The proposed amendment requires that, if applicable, franchisors make a prescribed statement that informs prospective franchisees that sometimes, current or former franchisees sign provisions restricting their ability to discuss their franchise experience. The proposal also offers franchisors two additional options: (1) a franchisor may disclose the number and percentage of current and former franchisees who have signed agreements with gag clauses within the last three years; and (2) a franchisor may explain the circumstances surrounding the gag clauses. However, because this proposal's only actual requirement is to include specific text provided by the Commission, it is exempt from the PRA. Therefore, no additional burden hours are associated with this proposal.

(9) Requiring Prescribed Statements About Financial Performance Representations. Proposed sections 436.5(s)(1) and (2) require franchisors to include in their disclosure documents two prescribed statements that clarify the law regarding financial performance representations. The first statement is mandatory for all franchisors, and makes clear that financial performance representations are allowed under certain circumstances. This statement combats a common misrepresentation -- that the FTC's Franchise Rule does not permit franchisors to make earnings representations. If franchisors do not provide financial representations, they must also include a second prescribed statement that includes an acknowledgment that they do not provide any type of financial performance representations, either oral or written. The proposed Rule provides the specific text that franchisors must use for both statements, and is therefore exempt from the PRA. Accordingly, no burden hours are associated with this proposed amendment.

(10) Recordkeeping Requirements. The proposed amended Rule would set forth two recordkeeping requirements. As an initial matter, proposed section 436.5(w) adds a requirement that franchisors include in their disclosure document a receipt that prospective franchisees must sign and return at least five days before a franchise agreement is signed or the franchisee pays any franchise fee. The proposal also requires franchisors to keep signed receipts for each completed franchise sale for at least three years. This proposed item contains the required language and format for the receipt, and the franchisor must only fill-in its franchise-specific information. Franchisors are also required to include a receipt under the current UFOC Guidelines. Thus, there is very little burden associated with producing the receipt.

Further, proposed section 436.5(w) would require franchisors to retain a copy of the signed receipts for at least three years. In addition, proposed section 436.7(g) would require franchisors who elect to furnish disclosures electronically to retain a specimen copy of each materially different version of their disclosure document for a period of three years. These recordkeeping provisions should impose a *de minimis* additional burden on franchisors. Many franchisors already retain sales receipt in order to comply with state regulations. In addition, we

can assume that a large number of franchisors would retain receipts as well as copies of their disclosures in the ordinary course of business. Thus, the few franchisors who do not already retain these records in the ordinary course of business will experience an increased paperwork burden. We therefore estimate that franchisors, on average, will require 30 minutes per year to maintain these records for a total increase of 1,188 hours and $297,000.

Total cost to comply with the Franchise Rule = $12,165,750 ($19,925,000 - $7,759,250)
Revised total annual burden hours = 19,363 (33,500 - 14,137)

Organizations and individuals desiring to submit comments on the information collection requirements should direct comments to the Office of Information and Regulatory Affairs, OMB, Room 10235, New Executive Office Building, Washington, D.C. 20503; Attention: Desk Officer for the Federal Trade Commission.

The FTC considers comments by the public on these collections of information in:

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have a practical use;
- Evaluating the accuracy of the agency's estimate of the burden of the collection of information, including the validity of the methodology and assumptions used;
- Enhancing the quality, usefulness, and clarity of the information to be collected; and
- Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated electronic, mechanical, or other technological collection techniques or other forms of information technology; *e.g.*, permitting electronic submission of responses.

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the *Federal Register*. Therefore, a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days of publication. This does not affect the deadline for the public to comment to the agency on the proposed regulations.

Section H -- Request for Comments

The Commission invites members of the public to comment on any issues or concerns they believe are relevant or appropriate to the Commission's consideration of the proposed Franchise Rule amendments. The Commission requests that factual data upon which the comments are based be submitted with the comments. In addition to the issues raised above, the Commission solicits public comment on the specific questions identified below. These questions are designed to assist the public and should not be construed as a limitation on the issues on which public comment may be submitted.

1. General Questions:

Please provide comment, including relevant data, statistics, consumer complaint information, or any other evidence, on each different proposed change to the Rule. Regarding each proposed revision commented on, please include answers to the following questions:

(a) What is the impact (including any benefits and costs), if any, on:
1. prospective franchisees;
2. existing franchisees; and
3. franchisors (including small franchisors and start-up franchisors)?

(b) What alternative proposals should the Commission consider? How would these proposed alternatives affect the costs and benefits of the proposed Rule?

2. Questions on Specific Proposed Changes:

In response to each of the following questions, please provide: (1) detailed comment, including data, statistics, consumer complaint information, and other evidence, regarding the issues addressed in the question; (2) comment as to whether the proposed changes do or do not provide an adequate solution to the problems they were intended to address; and (3) suggestions for additional changes that might better maximize consumer protections or minimize the burden on franchisors.

Definitions:

1. The proposed definition of "financial performance representation" -- section 436.1(d) -- includes any representation that "states or suggests" a value or range of potential or actual financial performance. This definition seeks to make clear that implied earnings representations are considered financial performance representations. Does this definition clarify what the Commission considers to be financial performance representations? If not, what alternative definition should the Commission consider?

2. Based upon the UFOC model, the proposed Rule requires franchisors to disclose various expenses, including the initial franchise fee (proposed 436.5(e)), recurring or occasional fees (proposed 436.5(f)), and estimated initial investment (proposed 436.5(g)). While the Commission does not consider the disclosure of such expense information alone to constitute the making of a financial performance claim, others arguably may interpret some expense information as implying a financial performance representation, such as a break-even point. To avoid any confusion, the proposed definition of "financial performance representation" -- section 436.l(d) -- specifically omits expense information. Is the omission of expense information from the proposed definition sufficient to make clear that compliance with the Rule's expense disclosure obligations does not trigger the Rule's Item 19 financial performance substantiation requirements? At the same time, could the proposed definition inadvertently be interpreted as permitting franchisors to disclose additional, non-required expense data without complying with the Rule's Item 19 requirements? If so, could franchisors make "back-door" earnings

representations in the guise of additional expense information? What alternative definition should the Commission consider?

3. The proposed definition of the term "franchise" -- section 436.1(g) -- is designed to include franchises that traditionally have been covered by the Rule, while eliminating ordinary business opportunities that will be covered by a separate business opportunity rule. Does the proposed revised definition capture the appropriate universe of franchises? Does the definition inadvertently eliminate businesses that should be considered franchises?

4. The proposed definition of "franchise seller" -- section 436.1(h) -- combines into a single concept the current terms "franchisor" and "franchise broker." This alleviates the necessity for using both terms when discussing obligations to furnish documents. It also seeks to clarify who is considered to be a franchise seller. Does the proposed definition include the appropriate persons? Are there other persons that should be included in the definition?

5. Proposed section 436.1(k) provides a definition of the term "gag clause," which refers to contractual provisions that prohibit or restrict franchisees' ability to discuss their own personal experiences within the franchise system. Does this proposed definition clearly identify the types of provisions that are considered gag clauses? Does the use of the term "gag clause" accurately describe these types of contractual provisions? Is there another term that would be preferable?

6. Proposed section 436.l(l) provides a broad definition of the term "Internet," which refers to *all* computer-to-computer communications, including the World Wide Web, and communications between computers and television, telephone, facsimile, and similar communications devices. Given the rapidly evolving computer environment, does this definition allow enough room -- or too much room -- for new types of computer communication? Is the definition consistent with other agencies' definitions of Internet?

7. The proposed definition of officer -- section 436.1(o) -- includes "a *de facto* officer," an individual with significant management responsibility whose title does not adequately reflect the nature of the position. This revised definition, based upon the UFOC Guidelines, clarifies that the actual functions a person performs within a company, whether or not the person possesses a title, will be considered when determining if the individual is subject to the disclosure provisions in proposed sections 436.3 - 436.5. Is the proposed definition sufficient to enable franchisors to determine who is deemed to be an officer for purposes of the Rule? What alternative definition might be appropriate?

8. The proposed definition of "signature" -- section 436.1(w)-- refers to a person's affirmative steps to authenticate his or her identity. This includes both written and electronic signatures. In light of the growing use of electronic communications, is the expansion of the Rule to include electronic signatures desirable? Are there sufficient safeguards in place to discourage unlawful uses of electronic signatures?

Liability:

9. The proposed Rule sets forth a new standard of liability. Proposed section 436.2(c) would hold franchisors liable for any failure to comply with the disclosure requirements and instructions set forth in sections 436.3-436.8. In contrast, proposed section 436.2(c) would hold other sellers (such as the franchisor's employees and sales representatives) liable for violations of sections 436.3-436.8 only if they "knew or should have known of the violation." What are the costs and benefits of holding other franchise sellers liable for Rule violations? If other franchise sellers are to be held liable, is a "knew or should have known" standard appropriate? What alternative standards of liability should the Commission consider?

Timing Provisions:

10. Proposed section 436.2(a)(1) would require franchisors to provide disclosure documents at least 14 days before a prospective franchisee either signs a binding agreement or pays a fee in connection with the franchise sale. This proposal would eliminate the current "10 business day" period in favor of a bright line "14 days." Is this modification desirable? What alternatives should the Commission consider?

11. Proposed section 436.2(a)(2) would require the franchisor to provide a copy of its completed contract at least five days before the prospective franchisee signs the contract. This proposal would eliminate the current "five business day" period in favor of a bright line "five days." Does this proposal afford prospective franchisees sufficient time to conduct a due diligence review of a franchise offering? If five days does not provide a sufficient review period, what would be an appropriate review period?

Disclosures:

12. Proposed section 436.5 retains the current Rule requirement that franchisors disclose information concerning their predecessors. What are the costs and benefits of this disclosure requirement? In particular, is information about predecessors useful to prospective franchisees in deciding whether to purchase a franchise from the current franchisor? Further, the proposed Rule would require franchisors to disclose information about predecessors during the past 10 years. Is this information readily available to franchisors? Should the disclosure be limited to information about the franchisor's immediate predecessor?

13. Proposed section 436.5(c)(ii) would require franchisors to disclose all pending material civil actions involving the franchise relationship. Would these additional disclosures provide prospective franchisees with useful information? Would it be advisable to limit the scope of the disclosure, by providing, for example, that a franchisor would not have to make the disclosure unless it had sued a certain threshold percentage of its franchisees? If so, would a 5% threshold be appropriate? What other alternatives should the Commission consider?

14. Proposed section 436.5(k) requires franchisors to disclose information about whether they require their franchisees to purchase or use electronic cash registers and computer systems. Franchisors must also disclose detailed information about any required systems. Does this proposal sufficiently specify what information is required to be disclosed? Does this proposal unduly burden franchisors, in particular start-up franchisors, who may not possess specific computer requirements at the time the disclosure document is prepared? What alternatives should the Commission consider?

15. Proposed section 436.5(1)(2)(ii) would require franchisors that do not offer exclusive territories to make the statement: "You will not receive an exclusive territory. [Franchisor] may establish other franchised or franchisor-owned outlets that may compete with your location." Does this statement sufficiently alert prospective franchisees about potential competition from within the franchise system? What alternative statement would be appropriate?

16. Proposed section 436.5(1) requires franchisors to disclose whether they offer protected territories. Should proposed section 436.5(l) also require franchisors to disclose their current development plans? Is such information proprietary? What costs and benefits would be involved in disclosing current development plans?

17. Proposed section 436.5(q), among other things, requires franchisors to disclose information about "renewals." Is the term "renewal" misleading? Does it imply that prospective franchisees will be able to extend their contracts for an additional period under the same terms and conditions as their current contract? Is there a distinction between an "extension" and a "renewal" of a contract? If the term "renewal" is misleading, what alternatives would be more accurate?

18. Proposed section 436.5(s), consistent with the UFOC Guidelines, would eliminate the requirement that financial performance representations must be geographically relevant to the franchise being offered. Would this proposal have an impact on the number of franchisors making financial performance representations or on the quality of such representations?

19. Proposed sections 436.5(s)(3)(i)-(ii) detail the information franchisors must provide if they elect to make historical performance representations. Do these required disclosures provide prospective franchisees with sufficient information to assess the representation? How can these disclosures be improved?

20. Proposed sections 436.5(s)(3)(ii)(A) and (F) require franchisors that make financial performance representations to: (1) describe the characteristics of the outlets underlying the representation; and (2) describe how those characteristics may differ materially from those of the outlet that may be offered to a prospective franchisee. Do these sections provide franchisors with sufficient guidance about what characteristics they must disclose? How can these sections be improved? Are these characteristics sufficient to enable prospective franchisees to assess the relevance of the financial performance representation to the franchise

offering being considered? If not, what additional disclosures are desirable to provide prospective franchisees with the necessary information?

21. Proposed section 436.5(s)(3)(iv) retains the current requirement that franchisors making financial performance representations to prospective franchisees must include a conspicuous admonition that a new franchisee's individual financial results may differ from the results stated in the financial performance representation. Should this admonitions be required for all financial performance representations? If not, when is it unnecessary?

22. Commenters have noted that Item 20 may cause franchisors to "double count" franchise closures. How often and under what circumstances does this occur? Does the proposed section 436.5(t) approach solve the double counting problem? Do the instructions and sample tables provide sufficient guidance on how to present the required information?

23. If multiple events occur in the process of a change in the ownership or closure of a unit, proposed section 436.5(t)(1) directs franchisors to report that change under the heading for the event that occurred first (a "first-in-time" approach). For example, if a franchisor formally notifies a franchisee that the franchise agreement for a particular unit will be terminated, and the franchisee subsequently sells his rights back to the franchisor or to a third-party, the franchisor would record this series of events as a "termination," since that event occurred first. In many instances, this approach would capture terminations by the franchisor rather than any subsequent transfers or reacquisitions. Does this approach capture the right information? Is there any evidence that suggests that information about terminations by a franchisor is more meaningful to prospective franchisees than subsequent transfers or reacquisitions?

24. Instead of a first-in-time approach, should the Commission consider prioritizing the various events that may occur, so that franchisors would report unit closures and ownership changes that involve multiple events according to the highest assigned applicable category (an "order-of-priority" approach)?

A. Should the Commission adopt the order of priority set forth in columns (4) through (8) of the proposed Item 20 table? Like the first-in-time approach, this approach would tend to stress terminations and cancellations over reacquisitions and transfers. Under this approach, a franchisor would report events according to the following order: (1) termination or cancellation by the franchisor; (2) reacquisition by the franchisor for consideration (whether by payment or forgiveness or assumption of debt); (3) transfer by the franchisee to a new owner; (4) post-term non-renewals; and (5) events other than termination/cancellation, reacquisition, transfer, or post-term non-renewal.

B. Should the order of priority focus on reacquisitions and transfers over terminations and cancellations? Under this approach, a franchisor would report events according to the following order: (1) reacquisitions by the franchisor for consideration (whether by payment or forgiveness or assumption of debt); (2) transfer by the franchisee to a new owner; (3)

termination or cancellation by the franchisor; (4) post-term non-renewal; and (5) events other than reacquisition, transfer, termination/cancellation, or post-term non-renewal.

C. Are either of these approaches preferable to the first-in-time approach? Should the Commission consider other orders of priority? How might the application of a specific order of priority lead to different results than the first-in-time approach? What kinds of information would a specific order-of-priority approach tend to provide that is not available from the first-in-time approach? What evidence is there that prospective franchisees would find this additional information valuable to them?

25. Consistent with the UFOC guidelines, proposed section 436.5(t)(4) requires that franchisors disclose the names, addresses, and telephone numbers of either all of their franchisees or at least 100 of their franchisees. The current Rule requires that franchisors disclose the names, addresses, and telephone numbers of only 10 franchisees. What are the costs and benefits of disclosing the names, addresses, and telephone numbers of additional franchisees?

26. Proposed Item 20 -- section 436.5(t)(6) -- also includes a new provision that requires disclosure of information about the use of gag clauses. Would this proposal provide prospective franchisees with useful information? Will this proposal affect the ability of franchisors and franchisees to reach future settlements? Is the three-year reporting period appropriate? If not, should it be longer or shorter?

27. Proposed Item 20 -- section 436.5(t)(7) -- also would require franchisors to disclose information about trademark-specific franchisee associations. Would this provision provide prospective franchisees with useful information? Does the proposal strike the correct balance between costs imposed on franchisors and the benefits to prospective franchisees?

28. Proposed section 436(u)(2) sets forth the phase-in of audited financial statements for new franchisors. Do the instructions and table provide sufficient guidance on how to phase-in audited financial statements? Should the Commission consider alternative phase-in approaches?

29. Proposed section 436.5(w)(2) would require franchisors to prove that prospective franchisees actually received a disclosure document. Does this proposal serve a useful purpose? Do franchisors already retain similar records in the ordinary course of business? What alternative methods should the Commission consider?

30. The proposed Rule disclosures are based upon the UFOC Guidelines. As explained in this notice, however, there are several instances where the Commission intends the proposed Rule to differ from the UFOC Guidelines. Aside from those instances already noted, are there other instances where a proposed Rule provision appears to be inconsistent with the comparable UFOC provision in a material way?

Electronic Disclosures:

31. Proposed section 436.7(b) would permit franchisors to furnish disclosure documents electronically, and sets forth the conditions under which franchisors may do so. What approaches are other federal and state agencies taking regarding electronic disclosure? Is the Commission's proposal consistent with other federal and state agencies' approaches? Are there other approaches the Commission should consider?

32. Proposed section 436.7(b) would require franchisors who furnish disclosures electronically to provide prospective franchisees with a written summary document. One purpose of the summary document is to help ensure that prospective franchisees understand the importance of receiving a disclosure document and their rights if they cannot read an electronic version. Will this provision achieve that goal? Will the summary document add significantly to the costs associated in providing electronic disclosure documents?

Exemptions:

33. Proposed section 436.9 provides that certain franchise relationships are exempt from the Rule's disclosure requirements. Does this provision adequately inform franchisors that they nonetheless are subject to the applicable Rule prohibitions set forth at 436.10 (*i.e.*, failure to return refunds)?

34. Assuming business opportunities will be addressed in a separate rule, does proposed section 436.9(a), which retains the current $500 threshold for franchise sales, continue to serve a useful purpose? What threshold would ensure that the Franchise Rule continues to apply to transactions involving a "personally significant monetary investment?"

35. Proposed section 436.9(e)(1) would create a disclosure exemption for large investments. Is the proposed $1.5 million threshold appropriate? What alternative threshold would be preferable? Are the other protections included in this proposed exemption sufficient to limit it to only sophisticated investors? Specifically, is it appropriate to exclude funds received from the franchisor or affiliate towards the $1.5 million? Does the required franchisee acknowledgment add any additional protection to prospective franchisees?

36. Proposed section 436.9(e)(2) also creates a disclosure exemption for large corporate investors. Do the proposed five years in business and $5 million net worth requirements accurately characterize the type of corporate investors that should be excluded from Rule coverage? Should the limits be raised or lowered? What other alternatives should the Commission consider in determining the proper class of exempted corporate-investors?

37. Does proposed section 436.9(e) adequately address the impact of inflation on the proposed sophisticated investor thresholds? Are there more effective ways of adjusting for inflation? Does the inherent uncertainty in an inflation adjustment present problems to franchisors or prospective franchisees? If the Commission publishes its inflation-adjusted thresholds several months before their effective dates, would that provide sufficient notice to franchisors or prospective franchisees?

Miscellaneous:

38. Proposed section 436.10(e) would prohibit franchisors from disclaiming (or requiring a franchisee from waiving reliance on) any statement made in a disclosure document. Would this proposal serve a useful purpose? What are the potential costs and benefits associated with the proposal? What alternatives should the Commission consider to ensure that prospective franchisees can rely on the accuracy of statements made in a disclosure document?

39. Proposed section 436.11(b) states that franchisors can petition the Commission to amend any outstanding FTC order that applies to any franchisor that may be inconsistent with any provision of the revised Rule. Is this express reference to the opportunity for order modification by the Commission needed?

40. Should the Commission revise the Franchise Rule to add a requirement that franchisors state in their disclosure documents the name, business address, and telephone number of the primary individuals who were responsible for preparing the disclosure document? This proposal would be similar to franchisors including information about the accounting firm that prepared their audited financial statements. Would such a requirement improve the quality of advice that prospective franchisors are given by their advisors? Could this requirement help reduce fraud in the sale of franchises, by giving advisors an incentive to be more cautious about advising clients who may be ill-prepared financially or otherwise to enter into franchising or to support a franchise system?

Section I -- Proposed Rule

List of Subjects in 16 CFR Part 436

Advertising, Business and industry, Franchising, Trade practices.

Accordingly, it is proposed that part 436 of title 16 of the Code of Federal Regulations, be amended to read as follows:

PART 436 -- DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING

DEFINITIONS

Sec.

436.1 Definitions.

OBLIGATIONS OF FRANCHISORS AND OTHER FRANCHISE SELLERS

436.2 Furnishing and preparing disclosure documents.

THE CONTENTS OF A DISCLOSURE DOCUMENT

INSTRUCTIONS

OTHER PROVISIONS

AUTHORITY: 15 U.S.C. 41-58.
SOURCE:

DEFINITIONS

§ 436.1 Definitions.

Unless stated otherwise, the following definitions shall apply throughout this rule:

(a) *Action* includes complaints, cross claims, counterclaims, and third-party complaints in a judicial proceeding, and their equivalents in an administrative action or arbitration proceeding.

(b) *Affiliate* means an entity controlled by, controlling, or under common control with the franchisor.

(c) *Disclose* means to state all material facts accurately, clearly, concisely, and legibly in plain English.

(d) *Financial performance representation* means any oral, written, or visual representation to a prospective franchisee, including a representation disseminated in the general media and Internet, that states or suggests a specific level or range of potential or actual sales, income, gross profits, or net profits. A chart, table, or mathematical calculation that

demonstrates possible results based upon a combination of variables is a financial performance representation.

(e) *Fiscal year* refers to the franchisor's fiscal year.

(f) *Fractional franchise* means a franchise relationship, which when the relationship is created:

(1) The franchisee or any of the franchisee's current directors or officers has more than two years of experience in the same type of business; and

(2) The parties reasonably anticipate that the sales arising from the relationship will not exceed more than 20 percent of the franchisee's total dollar volume in sales during the first year of operation.

(g) *Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller represents, orally or in writing, that:

(1) The franchisee obtains the right to operate a business or offer, sell, or distribute goods, commodities, or services that are identified or associated with the franchisor's trademark;

(2) The franchisor:

(i) Exerts or has authority to exert a significant degree of continuing control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, or marketing plan; or

(ii) Provides significant assistance in the franchisee's method of operation (*e.g.*, the franchisee's business organization, promotional activities, management, or marketing plan), extending beyond the start of the business operation. Promotional assistance alone, however, will not constitute "significant" assistance in the absence of other forms of assistance; and

(3) As a condition of obtaining or commencing operation of the business, the franchisee is required by contract or by practical necessity to make a payment, or a commitment to pay, to the franchisor or a person affiliated with the franchisor.

(h) *Franchise seller* means a person that offers for sale, sells, or arranges for the sale of an interest in a franchise. It includes the franchisor and its employees, representatives, agents, and third-party brokers. It does not include franchisees who sell only their own outlets.

(i) *Franchisee* means any person who is granted an interest in a franchise.

(j) *Franchisor* means any person who grants an interest in a franchise and participates in the franchise relationship.

(k) *Gag clause* means any contractual provision entered into by a franchisor and a current or former franchisee that prohibits or restricts that franchisee from discussing his or her personal experience as a franchisee within the franchisor's system. It does not include confidentiality agreements that protect franchisors' trademarks or other proprietary information.

(l) *Internet* means all communications between computers and between computers and television, telephone, facsimile, and similar communications devices. It includes the World Wide Web, proprietary online services, E-mail, newsgroups, and electronic bulletin boards.

(m) *Leased department* means an arrangement whereby a retailer licenses or otherwise permits an independent seller to conduct business from the retailer's premises.

(n) *Material, material fact,* and *material change* includes any fact, circumstance, or set of conditions that has a substantial likelihood of influencing a reasonable franchisee or prospective franchisee in making a significant decision.

(o) *Officer* means any individual with significant management responsibility for the marketing and/or servicing of franchises, such as the chief executive and chief operating officers, and the financial, franchise marketing, training, and service officers. It also includes a *de facto* officer, namely an individual with significant management responsibility for the marketing and/or servicing of franchises whose title does not reflect the nature of the position.

(p) *Person* means any individual, group, association, limited or general partnership, corporation, or any other business entity.

(q) *Plain English* means the organization of information and language usage understandable by a person unfamiliar with the franchise business. It incorporates the following six principles of clear writing: Short sentences; definite, concrete, everyday language; active voice; tabular presentation of information; no legal jargon or highly technical business terms; and no multiple negatives.

(r) *Predecessor* means a person from whom the franchisor acquired, directly or indirectly, the major portion of the franchisor's assets or from whom the franchisor obtained a license to use the trademark or trade secrets in the franchise operation.

(s) *Principal business address* means the address of the franchisor's home office in the United States. A principal business address cannot be a post office box or private mail drop.

(t) *Prospective franchisee* means any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship.

(u) *Required payment* means all consideration that the franchisee must pay to the franchisor or its affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise.

(v) *Sale of a franchise* includes an agreement whereby a person obtains a franchise or interest in a franchise for value by purchase, license, or otherwise. It does not include extending or renewing an existing franchise agreement where there is no interruption in the franchisee's

operation of the business, unless the new agreement contains terms and conditions that differ materially from the original agreement.

(w) *Signature* means a person's affirmative steps to authenticate his or her identity. It includes a person's written signature, as well as a person's use of security codes, passwords, digital signatures, and similar devices.

(x) *Trademark* includes trademarks, service marks, names, logos, and other commercial symbols.

(y) *Written* means any information in printed form or in any form capable of being preserved in tangible form and read. It includes: type-set, word processed, or handwritten documents; documents on computer disk or CD-Rom; documents sent via E-mail; or documents posted on the Internet. It does not include mere oral statements.

OBLIGATIONS OF FRANCHISORS AND OTHER FRANCHISE SELLERS

§ 436.2 The Obligation To Furnish Documents.

In connection with the offer or sale of a franchise to be located in the United States of America, its territories, or possessions, unless the transaction is exempted under the provisions of section 436.9, it is an unfair or deceptive act or practice in violation of section 5 of the Federal Trade Commission Act:

(a) For any franchise seller to fail to furnish a prospective franchisee with the following documents within the following time frames. The obligations set forth in this subsection are satisfied if either the franchisor or other franchise seller furnishes the required documents to the prospective franchisee:

(1) ***A current disclosure document***. A copy of the franchisor's current disclosure document, as described in sections 436.3 - 436.8, at least 14 days before the prospective franchisee signs a binding agreement or pays any fee in connection with the proposed franchise sale; and

(2) ***Completed franchise agreement.*** A copy of the completed franchise agreement, and any related agreements, at least five days before the prospective franchisee signs the franchise agreement.

(b) For purposes of this section, a franchise seller will be considered to have furnished the documents by the required date if a copy of the document -- either a paper copy or, with the consent of the prospective franchisee, an electronic copy -- has been delivered to the prospective franchisee by that date, or if a copy has been sent to the address specified by the prospective

franchisee by first-class mail at least three days prior to the specified date. Documents shall also be considered to have been furnished by the required date if a copy has been sent by electronic mail or if directions for accessing the document on the Internet have been provided to the prospective franchise by that date.

(c) For any franchisor to fail to include the information and follow the instructions required by sections 436.3 - 436.8 in preparing the disclosure document to be furnished to prospective franchisees. Any other franchise seller shall be liable for violations of these sections if they knew or should have known of the violation.

THE CONTENTS OF A DISCLOSURE DOCUMENT

§ 436.3 Cover page.

Begin the disclosure document with a cover page that consists of the following:

(a) The title "**FRANCHISE DISCLOSURE DOCUMENT**" in boldface type.

(b) The franchisor's name, type of business organization, principal business address, telephone number, and, if applicable, E-mail address and primary Internet home page address.

(c) A sample of the primary business trademark under which the franchisee will conduct its business.

(d) A brief description of the franchised business.

(e) The total amounts in Item 5 (Initial Franchisee Fee) and Item 7 (Estimated Initial Investment) of the disclosure document.

(f) The issuance date.

(g) The following statements in the order and form shown below:

(1) **This disclosure document summarizes certain provisions of the franchise agreement and other information in plain English. Read this disclosure document and all agreements carefully. You must receive this disclosure document at least 14 days before you sign a binding agreement or pay any fee. You must also receive completed copies of all contracts at least five days before you sign them.**

(2) If the franchisor furnishes an electronic version of its disclosure document, also insert the following:

You may have elected to receive an electronic version of your disclosure document. If so, you may wish to print or download the disclosure document for future reference. You have the right to receive a paper copy of the disclosure document up

until the time of sale. To obtain a paper copy, contact [name] at [address] and [telephone number].

(3) Buying a franchise is a complicated investment. The information contained in this disclosure document can help you make up your mind. **Note, however, that the Federal Trade Commission (FTC) has not checked the information and does not know if it is correct.** Information comparing franchisors is available. Call your State agency or your public library for sources of information. Additional information on franchising, such as "A Consumer's Guide to Buying a Franchise," is available from the FTC. You can contact the FTC in Washington, D.C., or visit the FTC's home page at <www.ftc.gov> for further information. In addition, there may be laws on franchising in your State. Ask your State agencies about them.

(4) You should also know that the terms and conditions of your contract will govern your franchise relationship. While the disclosure document includes some information about your contract, don't rely on it alone to understand your contract. Read all of your contract carefully. Show your contract and this disclosure document to an advisor, like a lawyer or an accountant.

(5) **Federal Trade Commission, Washington, DC 20580**

(h) Franchisors may include additional disclosures on the cover page, or on a separate cover page, to comply with any applicable State pre-sale disclosure laws.

§ 436.4 Table of Contents.

Include the following table of contents. State the page where each disclosure Item begins. List all exhibits by letter, following the example shown below.

TABLE OF CONTENTS

ITEM **PAGE**

15. Obligation to Participate in the Actual Operation of the Franchise Business
16. Restrictions on What the Franchisee May Sell
17. Renewal, Termination, Transfer, and Dispute Resolution
18. Public Figures
19. Financial Performance Representations
20. Outlets and Franchisee Information
21. Financial Statements
22. Contracts
23. Receipt

EXHIBITS
A. Franchise Agreement

§ 436.5 Disclosure Items

(a) ***Item 1: The Franchisor, Its Parents, Predecessors, and Affiliates*****.**

(1) Disclose the name of the franchisor. Also disclose the names of any parent and affiliates of the franchisor and the relationship with the franchisor. For purposes of Item 1, the term "affiliate" means an entity controlled by, controlling, or under common control with the franchisor, that offers franchises in any line of business or is providing products or services to the franchisees of the franchisor.

(2) Disclose the name of any predecessors during the 10-year period immediately before the close of the franchisor's most recent fiscal year.

(3) Disclose the name under which the franchisor does or intends to do business.

(4) Disclose the principal business address of the franchisor, its parent, predecessors, and affiliates, and the franchisor's agent for service of process.

(5) Disclose the type of business organization used by the franchisor (*e.g.*, corporation, partnership), and the State in which it was organized.

(6) Disclose the following information about the nature of the franchisor's business and the franchises to be offered:

(i) Whether the franchisor operates businesses of the type being franchised;

(ii) The franchisor's other business activities;

(iii) The business to be conducted by the franchisee;

(iv) The general market for the product or service to be offered by the franchisee. In describing the general market, consider factors such as whether the market is developed or developing, whether the goods will be sold primarily to a certain group, and whether sales are seasonal;

(v) In general terms, any laws or regulations specific to the industry in which the franchise business operates;[281] and

[281] Only laws pertaining specifically to the industry sector of the franchised business, and not (continued...)

(vi) A general description of the competition.

(7) Disclose the prior business experience of the franchisor, its parent, predecessors, and affiliates, including:

(i) The length of time each has conducted the type of business to be operated by the franchisee;

(ii) The length of time each has offered franchises providing the type of business to be operated by the franchisee; and

(iii) Whether each has offered franchises in other lines of business, including:

(A) A description of each other line of business;

(B) The number of franchises sold in each other line of business; and

(C) The length of time offering each other line of business.

(b) ***Item 2: Business Experience.*** Disclose the position and name of the directors, trustees, general partners, officers, and subfranchisors of the franchisor or any parent who will have management responsibility relating to the offered franchises. List all franchise brokers. For each person listed, state the principal positions and employers during the past five years, including each position's beginning date, ending date, and location.

(c) ***Item 3: Litigation*****.**

(1) Disclose whether the franchisor, its parent, predecessor, a person identified in Item 2, or an affiliate who offers franchises under the franchisor's principal trademark:

(i) Has pending against that person:

(A) An administrative, criminal, or material civil action alleging a violation of a franchise, antitrust, or securities law, or alleging fraud, unfair or deceptive practices, or comparable allegations; or

(B) Civil actions, other than ordinary routine litigation incidental to the business, which are significant in the context of the number of franchisees and the size, nature, or financial condition of the franchise system or its business operations.

(ii) Is a party to any pending material civil action involving the franchise relationship. For purposes of this item, "franchise relationship" means contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business (*e.g.*, royalty payment and training obligations). It does not include suits involving third-parties such as suppliers or indemnification for tort liability.

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[281](...continued)
businesses generally, must be disclosed in this Item. For example, a real estate brokerage franchisor should disclose the existence of broker licensing laws; 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 environmental laws regulating pesticide application to residential lawns will require that franchisees post notices on treated lawns. It is not necessary to include laws or regulations that apply to businesses generally, such as general business licensing laws, tax regulations, or labor laws.

(iii) Has during the 10-year period immediately before the disclosure document's issuance date:

(A) Been convicted of a felony or pleaded *nolo contendere* to a felony charge;

(B) Been held liable in a civil action by final judgment. "Held liable" means that, as a result of claims or counterclaims, the franchisor must pay money or other consideration, must reduce an indebtedness by the amount of an award, cannot enforce its rights, or must take action adverse to its interests; or

(C) Been a defendant in a material action involving an alleged violation of a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive practices, or comparable allegations.[282]

(iv) Is subject to a currently effective injunctive or restrictive order or decree resulting from a pending or concluded action brought by a public agency and relating to the franchise or to a Federal, State, or Canadian franchise, securities, antitrust, trade regulation, or trade practice law.

(2) For each action identified above, state the title, case number or citation, the initial filing date, the names of the parties, and the forum. State the relationship of the opposing party to the franchisor (*e.g.*, competitor, supplier, lessor, franchisee, former franchisee, or class of franchisees). Summarize the legal and factual nature of each claim in the action, the relief sought or obtained, and any conclusions of law or fact.[283] In addition:

(i) For pending actions, state the status of the action;

(ii) For prior actions, state the date when the judgment was entered and any damages and/or settlement terms;[284]

(iii) For injunctive or restrictive orders, state the nature, terms, and conditions of the order or decree; and

(iv) For convictions or pleas, state the crime or violation, the date of conviction, and the sentence or penalty imposed.

(d) ***Item 4: Bankruptcy*****.**

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[282] Franchisors are not required to disclose actions that were dismissed by final judgment without liability or entry of an adverse order. However, franchisors must disclose dismissal of a material action in connection with a settlement.

[283] Franchisors may include a summary opinion of counsel concerning any action if a consent to use the summary opinion is included as part of the disclosure document.

[284] If a settlement agreement must be disclosed in this Item, all material settlement terms must be disclosed, whether or not the agreement is confidential. Because of difficulties in retrieving information and/or obtaining releases from older confidentiality agreements, franchisors are not required to disclose the settlement terms of settlements entered before April 15, 1993, consistent with the policy adopted by the North American Securities Administrators Association's Uniform Franchise Offering Circular Guidelines.

(1) Disclose whether the franchisor, its parent, predecessor, a person identified in Item 2, or an affiliate who offers franchises under the franchisor's principal trademark has, during the 10-year period immediately before the date of this disclosure document:

(i) Filed as debtor (or had filed against it) a petition under the U.S. Bankruptcy Code ("Bankruptcy Code");

(ii) Obtained a discharge of its debts under the Bankruptcy Code; or

(iii) Been a principal officer of a company or a general partner in a partnership that either filed as a debtor (or had filed against it) a petition under the Bankruptcy Code or that obtained a discharge of its debts under the Bankruptcy Code while or within one year after the officer or general partner held the position in the company.

(2) For each bankruptcy:

(i) State the name, address, and principal business of the debtor;

(ii) If the debtor is not the franchisor, state the relationship of the debtor to the franchisor (*e.g.*, affiliate, officer); and

(iii) State the date of the original filing. Identify the bankruptcy court, and the case name and number. If applicable, state the debtor's discharge date, including discharges under Chapter 7 and confirmation of any plans of reorganization under Chapters 11 and 13 of the Bankruptcy Code.

(3) Disclose cases, actions, and other proceedings under the laws of foreign nations relating to bankruptcy, as if they took place under the Bankruptcy Code.

(e) ***Item 5: Initial Franchise Fee.*** Disclose the initial franchise fee and the conditions under which this fee is refundable. If the initial fee is not uniform, disclose the range or the formula used to calculate the initial fees paid in the fiscal year before the issuance date and the factors that determined the amount. For purposes of this Item, "initial fee" means all fees and payments for services or goods received from the franchisor before the franchisee's business opens, whether payable in lump sum or installments.

(f) ***Item 6: Recurring or Occasional Fees.*** Disclose, in the tabular form shown below, any recurring or occasional fees that the franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates impose or collect in whole or in part on behalf of a third party. Include any formula used to compute the fees.[285]

(1) Type of Fee	(2) Amount	(3) Due Date	(4) Remarks

[285] If fees may increase, disclose the formula that determines the increase or the maximum amount of the increase. For example, a percentage of gross sales is acceptable if the franchisor defines the term "gross sales."

(1) In column (1), disclose the type of fee (*e.g.*, royalties, and fees for lease negotiations, construction, remodeling, additional training or assistance, advertising, advertising cooperatives, purchasing cooperatives, audits, accounting, inventory, transfers, and renewals).

(2) In column (2), disclose the amount of each fee.

(3) In column (3), disclose the applicable due date for recurring fees.

(4) In column (4), include any relevant remarks, definitions, or caveats that elaborate on the information in the table. If remarks are lengthy, franchisors may use footnotes instead of the remarks column. If applicable, include the following information in the remarks column or in a footnote:

(i) If the fees are payable only to the franchisor;

(ii) If the fees are imposed and collected by the franchisor;

(iii) The terms and conditions under which any fee is refundable; and

(iv) The voting power of franchisor-owned outlets on any fees imposed by cooperatives. If franchisor-owned outlets have controlling voting power, disclose the maximum and minimum fees that may be imposed.

(g) ***Item 7: Estimated Initial Investment.*** Disclose, in the tabular form shown below, the franchisee's estimated initial investment. Title the table "Your Estimated Initial Investment For The First [reasonable initial phase] Months." A reasonable initial phase is at least three months or a reasonable period for the industry. Franchisors may include additional expenditure tables to show expenditure variations caused by differences such as in site location and premises size.

YOUR ESTIMATED INITIAL INVESTMENT FOR THE FIRST [reasonable initial phase] MONTHS

(1) Type of Expenditure	(2) Amount	(3) Method of Payment	(4) When Due	(5) To Whom Paid
Total				

(1) In column (1), disclose each type of expense, beginning with pre-opening expenses. Include the following expenses, if applicable. Use footnotes to comment on expenditures.

(i) The initial franchise fee.

(ii) Training expenses.

(iii) Real property, whether purchased or leased.

(iv) Equipment, fixtures, other fixed assets, construction, remodeling, leasehold improvements, and decorating costs, whether purchased or leased.

(v) Inventory required to begin operation.

(vi) Security deposits, utility deposits, business licenses, and other prepaid expenses.

(vii) List separately and by name any other specific payment (*e.g.*, additional training, travel, or advertising expenses).

(viii) Include an additional expense category named "other payments" for any other miscellaneous expenses that the franchisee will incur before operations begin and during the initial phase.

(2) In column (2), state the amount of the payment. If the specific amount is not ascertainable, use a low-high range based on the franchisor's current experience. If real property costs cannot be estimated in a low-high range, disclose the approximate size of the property and building, and describe the probable location of the building (*e.g.*, strip shopping center, mall, downtown, rural, or highway).

(3) In column (3), disclose the method of payment.

(4) In column (4), disclose the applicable due date.

(5) In column (5), disclose to whom payment will be made.

(6) Total the initial investment, incorporating ranges of fees, if used.

(7) Disclose in a footnote:

(i) The conditions under which each payment is refundable; and

(ii) If the franchisor or an affiliate finances part of the initial investment, the amount that it will finance, the required down payment, the annual percentage rate of interest, rate factors, and the estimated loan repayments. Franchisors may refer the reader to Item 10 for additional details.

(h) ***Item 8: Restrictions on Sources of Products and Services.*** Disclose franchisees' obligations to purchase or lease goods, services, fixtures, equipment, real estate, or comparable items related to establishing or operating the franchised business either (1) from the franchisor, its designee, or suppliers approved by the franchisor, or (2) under the franchisor's specifications. Include obligations to purchase imposed by written agreement or by the franchisor's practice.[286] For each applicable obligation:

(1) Disclose the item required to be purchased or leased.

(2) Disclose whether the franchisor or its affiliates are either approved suppliers or the only approved suppliers of that item.

(3) Disclose how the franchisor grants and revokes approval of alternative suppliers. State:

(i) The criteria for evaluating, approving, or disapproving of alternative suppliers;

(ii) Whether the franchisor permits franchisees to contract with alternative suppliers who meet the franchisor's criteria;

(iii) Any fees and procedures to secure approval;

(iv) How approvals are revoked; and

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[286] Franchisors may include the reason for the requirement. Franchisors are not required to disclose in this Item the purchase or lease of goods or services provided as part of the franchise without a separate charge (*e.g.*, initial training, the cost for which is included in the franchise fee); such fees should be described in Item 5. Franchisors should not disclose fees already described in Item 6.

(v) The time period within which the franchisee will receive notification of approval or disapproval.

(4) Disclose whether the franchisor issues specifications and standards to franchisees, subfranchisees, or approved suppliers. Describe how the franchisor issues and modifies specifications.

(5) Disclose whether the franchisor or its affiliates will or may derive revenue or other material consideration as a result of required purchases or leases by franchisees.[287] Describe the precise basis by which the franchisor or its affiliates will or may derive such consideration by disclosing:

(i) The franchisor's total revenue;

(ii) The franchisor's revenues from all required purchases and leases of products and services;

(iii) The percentage of the franchisor's total revenues represented by the franchisor's revenues from required purchases or leases; and

(iv) If the franchisor's affiliates also sell or lease products or services to franchisees, disclose affiliate revenues from those sales or leases.

(6) Disclose the estimated proportion of these required purchases and leases to all purchases and leases by the franchisee in establishing and operating the franchised business.

(7) If a designated supplier will make payments to the franchisor as a result of purchases by franchisees, disclose the basis for the payment (*e.g.*, specify a percentage or a flat amount). For purposes of this Item, a "payment" includes the sale of similar goods or services to the franchisor at a lower price than that available to franchisees.

(8) Disclose the existence of purchasing or distribution cooperatives.

(9) Disclose whether the franchisor negotiates purchase arrangements with suppliers, including price terms, for the benefit of franchisees.

(10) Disclose whether the franchisor provides material benefits (*e.g.*, renewal or granting additional franchises) to a franchisee based on a franchisee's purchase of particular products or services or use of particular suppliers.

(i) ***Item 9: Franchisee's Obligations.*** Disclose, in the tabular form shown below, a list of the franchisees' principal obligations. Cross-reference each listed obligation with any applicable franchise agreement and disclosure document section(s). Respond to each listed obligation. If a particular obligation is not applicable, state "Not Applicable." Include additional obligations, as is warranted.

> **This table lists your principal obligations under the franchise and other agreements. It will help you find more detailed information about your obligations in these agreements and in other items of this disclosure document.**

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[287] Figures should be taken from the franchisor's most recent annual audited financial statement required in Item 21. If audited statements are not yet required, or if the entity deriving the income is an affiliate, disclose the sources of information used in computing revenues.

Obligation	Section in Agreement	Disclosure Document Item
a. Site selection and acquisition/lease		
b. Pre-opening purchases/leases		
c. Site development and other pre-opening requirements		
d. Initial and ongoing training		
e. Opening		
f. Fees		
g. Compliance with standards and policies/operating manual		
h. Trademarks and proprietary information		
i. Restrictions on products/ services offered		
j. Warranty and customer service requirements		
k. Territorial development and sales quotas		
l. Ongoing product/service purchases		
m. Maintenance, appearance, and remodeling requirements		
n. Insurance		
o. Advertising		
p. Indemnification		

q. Owner's participation/ management/staffing		
r. Records and reports		
s. Inspections and audits		
t. Transfer		
u. Renewal		
v. Post-termination obligations		
w. Non-competition covenants		
x. Dispute resolution		
y. Other (describe)		

(j) ***Item 10: Financing.***

(1) Disclose the terms and conditions of each financing arrangement,[288] including leases and installment contracts, that the franchisor, its agent, or affiliates offers directly or indirectly to the franchisee.[289] The franchisor may summarize the terms of each financing arrangement in tabular form, using footnotes to provide additional information. For a sample Item 10 table, see Appendix A. For each financing arrangement, disclose:

(i) A description of what the financing covers (*e.g.*, the initial franchise fee, site acquisition, construction or remodeling, initial or replacement equipment or fixtures, opening or ongoing inventory or supplies, or other continuing expenses);[290]

(ii) The identity of the lender(s) providing the financing and any relationship to the franchisor (*e.g.*, affiliate);

(iii) The amount of financing offered or, if the amount depends on an actual cost that may vary, the percentage of the cost that will be financed;

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[288] Payments due within 90 days on open account financing are not required to be disclosed under this section.

[289] Indirect offers of financing include a written arrangement between a franchisor or its affiliate and a lender, for the lender to offer financing to a franchisee; an arrangement in which a franchisor or its affiliate receives a benefit from a lender in exchange for financing a franchise purchase; and a franchisor's guarantee of a note, lease, or other obligation of the franchisee.

[290] Include specimen copies of the financing documents as an exhibit to Item 22. Cite the section and name of the document containing the financing terms and conditions.

(iv) The annual percentage rate of interest ("APR") charged, computed as provided by Sections 106-107 of the Consumer Protection Credit Act, 15 U.S.C. 1605-1606. If the APR may differ depending on when the financing is issued, disclose the APR on a specified recent date;

(v) The number of payments or the period of repayment;

(vi) The nature of any security interest required by the lender;

(vii) Whether a person other than the franchisee must personally guarantee the debt;

(viii) Whether the debt can be prepaid and the nature of any prepayment penalty;

(ix) The franchisee's potential liabilities upon default, including any:

(A) Accelerated obligation to pay the entire amount due;

(B) Obligations to pay court costs and attorney's fees incurred in collecting the debt;

(C) Termination of the franchise; or

(D) Liabilities from cross defaults such as those resulting directly from non-payment, or indirectly from the loss of business property; and

(x) Other material financing terms.

(2) Disclose whether any provisions of the loan agreement require franchisees to waive defenses or other legal rights (*e.g.*, confession of judgment), or bar the franchisee from asserting a defense against the lender, the lender's assignee or the franchisor. If so, describe the relevant provisions.

(3) Disclose whether the franchisor's practice or intent is to sell, assign, or discount to a third party all or part of the financing arrangement. If so, disclose:

(i) The assignment terms, including whether the franchisor will remain primarily obligated to provide the financed goods or services; and

(ii) That the franchisee may lose all its defenses against the lender as a result of the sale or assignment.

(4) Disclose whether the franchisor or an affiliate receives any payments for the placement of financing with the lender. If such payments exist:

(i) Disclose the amount or the method of determining the payment; and

(ii) Identify the source of the payment and the relationship of the source to the franchisor or its affiliates.

(k) ***Item 11: Franchisor's Assistance, Advertising, Computer Systems, and Training.*** Disclose the franchisor's principal assistance and related obligations as described below. For each obligation, cite the section number of the franchise agreement imposing the obligation. Begin by stating: "Except as listed below, [the franchisor] is not required to provide any assistance to you."

(1) Disclose the franchisor's pre-opening obligations to the franchisee including any assistance in:

(i) Locating a site and negotiating the purchase or lease of the site. Disclose:

(A) Whether the franchisor generally owns the premises and leases it to the franchisee;

(B) Whether the franchisor selects the site or approves an area within which the franchisee selects a site. Disclose further how and whether the franchisor must approve a franchisee-selected site;

(C) The factors that the franchisor considers in selecting or approving sites (*e.g.*, general location and neighborhood, traffic patterns, parking, size, physical characteristics of existing buildings, and lease terms);

(D) The time limit for the franchisor to locate or to approve or disapprove the site. Disclose further the consequences if the franchisor and franchisee cannot agree on a site.

(ii) Conforming the premises to local ordinances and building codes and obtaining any required permits;

(iii) Constructing, remodeling, or decorating the premises;

(iv) Hiring and training employees; and

(v) Providing for necessary equipment, signs, fixtures, opening inventory, and supplies. In addition, disclose further:

(A) Whether the franchisor provides these items directly or merely provides the names of approved suppliers;

(B) Whether the franchisor provides written specifications for these items; and

(C) Whether the franchisor delivers or installs these items;

(2) Disclose the typical length of time between the signing of the franchise agreement or the first payment of consideration for the franchise and the opening of the franchisee's business. Describe the factors that may affect the time period such as ability to obtain a lease, financing or building permits, zoning and local ordinances, weather conditions, shortages, or delayed installation of equipment, fixtures, and signs.

(3) Disclose the franchisor's obligations to the franchisee during the operation of the franchise, including any assistance in:

(i) Developing products or services to be offered by the franchisee to its customers;

(ii) Hiring and training employees;

(iii) Improving and developing the franchised business;

(iv) Establishing prices;

(v) Establishing and using administrative, bookkeeping, accounting, and inventory control procedures; and

(vi) Resolving operating problems encountered by the franchisee.

(4) Describe the advertising program for the franchise system. Disclose the following:

(i) The franchisor's obligation to conduct advertising, including:

(A) The media the franchisor may use;

(B) Whether media coverage is local, regional, or national;

(C) The source of the advertising (*e.g.*, an in-house advertising department or a national or regional advertising agency); and

(D) Whether the franchisor must spend any amount on advertising in the area or territory where the franchisee is located.

(ii) Disclose the conditions under which the franchisor permits franchisees to use their own advertising material.

(iii) Disclose whether there is an advertising council composed of franchisees that advises the franchisor on advertising policies. If so, disclose:

(A) How members of the council are selected;

(B) Whether the council serves in an advisory capacity only or has operational or decision-making power; and

(C) Whether the franchisor has the power to form, change, or dissolve the advertising council.

(iv) Disclose whether the franchisee must participate in a local or regional advertising cooperative. If so, disclose:

(A) How the area or membership of the cooperative is defined;

(B) How much the franchisee must contribute to the fund and whether other franchisees are required to contribute at a different rate;

(C) Whether the franchisor-owned outlets must contribute to the fund and, if so, whether it is on the same basis as franchisees;

(D) Who is responsible for administration of the cooperative (*e.g.*, franchisor, franchisees, or advertising agency);

(E) Whether cooperatives must operate from written governing documents and whether the documents are available for review by the franchisee;

(F) Whether cooperatives must prepare annual or periodic financial statements and whether the statements are available for review by the franchisee; and

(G) Whether the franchisor has the power to require cooperatives to be formed, changed, dissolved, or merged.

(v) Disclose whether the franchisee must participate in any other advertising fund. If so, disclose:

(A) Who contributes to the fund;

(B) How much the franchisee must contribute to the fund and whether other franchisees are required to contribute at a different rate;

(C) Whether the franchisor-owned outlets must contribute to the fund and, if so, whether it is on the same basis as franchisees;

(D) Who administers the fund;

(E) Whether the fund is audited and when it is audited;

(F) Whether financial statements of the fund are available for review by the franchisee; and

(G) Use of the fund in the most recently concluded fiscal year, the percentages spent on production, media placement, administrative expenses, and a description of any other use.

(vi) If all advertising funds are not spent in the fiscal year in which they accrue, explain how the franchisor uses the remaining amount. Indicate whether franchisees will receive a periodic accounting of how advertising fees are spent.

(vii) Disclose the percentage of advertising funds, if any, that the franchisor uses principally to solicit new franchise sales.

(5) Disclose whether the franchisor requires the franchisee to buy or use electronic cash registers or computer systems. If so, describe the systems generally in non-technical language.

(i) Identify each hardware component and software program by brand, type, and principal functions.

(A) If the hardware component or software program is the proprietary property of the franchisor, an affiliate, or a third party, state whether the franchisor, an affiliate, or a third party has the contractual right or obligation to provide ongoing maintenance, repairs, upgrades, or

updates. Disclose the current annual cost of any optional or required maintenance and support contracts, upgrades, and updates;

(B) If the hardware component or software program is the proprietary property of a third party, and no compatible equivalent component or program has been approved by the franchisor for use with the system to perform the same functions, identify the third party by name, business address, and telephone number, and state the length of time the component or program has been in continuous use by the franchisor and its franchisees;

(C) If the hardware component or software program is not proprietary, identify compatible equivalent components or programs that perform the same functions and indicate whether they have been approved by the franchisor.

(ii) State whether the franchisee has any contractual obligation to upgrade or update any hardware component or software program during the term of the franchise and, if so, whether there are any contractual limitations on the frequency and cost of the obligation.

(iii) For each electronic cash register system or software program, describe how it will be used in the franchisee's business, and the types of business information or data that will be collected and generated. State further whether the franchisor will have independent access to the information and data and, if so, whether there are any contractual limitations on the franchisor's right to access the information and data.

(6) Disclose the table of contents of the franchisor's operating manual(s) provided to franchisees as of the franchisor's last fiscal year-end or a more recent date. State further the number of pages devoted to each subject and the total number of pages in the manual as of this date. Alternatively, this disclosure may be omitted if the prospective franchisee views the manual before purchase of the franchise.

(7) Disclose the franchisor's training program as of the franchisor's last fiscal year-end or a more recent date.

(i) Describe the nature of the training program summarized in tabular form, as follows:

Training Program

Subject	Hours of Classroom Training	Hours of On-The-Job Training	Location

(A) In column (1), state the subjects taught.

(B) In column (2), state the hours of classroom training for each subject.

(C) In column (3), state the hours of on-the-job training for each subject.

(D) In column (4), state the location of the training for each subject.

(ii) Disclose how often training classes are held and the nature of the location or facility where training is held (*e.g.*, company, home, office, franchisor-owned store).

(iii) Describe the nature of instructional materials and the instructor's experience. State the length of experience of the instructor in the field and, specifically, with the franchisor. State only the experience that is relevant to the subject taught and the franchisor's operations;

(iv) Disclose any charges franchisees must pay for training and who must pay travel and living expenses of the enrollees in the training program;

(v) Disclose who may and who is required to attend the training. State whether the franchisee or other persons must complete the program to the franchisor's satisfaction. If successful completion is required, state how long after the signing of the agreement or before the opening of the business the training must be completed. If training is not mandatory, state the percentage of new franchisees that enrolled in the training program during the preceding 12 months; and

(vi) Whether any additional training programs and/or refresher courses are required.

(l) ***Item 12: Territory.***

(1) Disclose the following information concerning the franchisee's market area (with or without an exclusive territory):

(i) If applicable, the minimum area granted to the franchisee (*e.g.*, a specific radius, a distance sufficient to encompass a specified population, or another specific designation);

(ii) Whether the franchise is granted for a specific location or a location to be approved by the franchisor;

(iii) Any conditions under which the franchisor will approve the relocation of the franchised business or the franchisee's establishment of additional franchised outlets;

(iv) Whether the franchisor has established or may establish another franchisee who may also use the franchisor's trademark within the defined area;

(v) Whether the franchisor has established or may establish franchisor-owned outlets or other channels of distribution using the franchisor's trademark within the defined area;

(vi) Whether the franchisor or its affiliate has established or may establish other franchises or franchisor-owned outlets or another channel of distribution selling or leasing similar products or services under a different trademark within the defined area;

(vii) Restrictions on the franchisor regarding operating franchisor-owned stores or on granting franchised outlets for a similar or competitive business within the defined area;

(viii) Restrictions on franchisees from soliciting or accepting orders outside of their defined territories;

(ix) Restrictions on the franchisor from soliciting or accepting orders inside the franchisee's defined territory. State further any compensation that the franchisor must pay for soliciting or accepting orders inside the franchisee's defined territories; and

(x) Franchisee options, rights of first refusal, or similar rights to acquire additional franchises within the territory or contiguous territories.

(2) Describe any exclusive territory granted the franchisee.

(i) If the franchisor grants an exclusive territory, disclose:

(A) Whether continuation of the franchisee's territorial exclusivity depends on achievement of a certain sales volume, market penetration, or other contingency, and under what circumstances the franchisee's territory may be altered. Specify any sales or other conditions. State the franchisor's rights if the franchisee fails to meet the requirements; and

(B) Any other circumstances that permit the franchisor to modify the franchisee's territorial rights (*e.g.*, a population increase in the territory giving the franchisor the right to grant an additional franchise within the area), and the effect of such modifications on the franchisee's rights;

(ii) If the franchisor does not grant exclusive territories, state: "**You will not receive an exclusive territory. [Franchisor] may establish other franchised or franchisor-owned outlets that may compete with your location**."

(3) If the franchisor or an affiliate operates, franchises, or has present plans to operate or franchise a business under a different trademark and that business sells goods or services similar to those to be offered by the franchisee, describe:

(i) The similar goods and services;

(ii) The trade names and trademarks;

(iii) Whether outlets will be franchisor owned or operated:

(iv) Whether the franchisor or its franchisees who use the different trademark will solicit or accept orders within the franchisee's territory;

(v) A timetable for the plan;

(vi) How the franchisor will resolve conflicts between the franchisor and the franchisees and between the franchisees of each system regarding territory, customers or franchisor support; and

(vii) The principal business address of the franchisor's similar operating business. If it is the same as the franchisor's principal business address disclosed in Item 1, disclose whether the franchisor maintains (or plans to maintain) physically separate offices and training facilities for the similar competing business.

(m) ***Item 13: Trademarks.***

(1) Disclose each principal trademark to be licensed to the franchisee. For purposes of this Item, "principal trademark" means the primary trademarks, service marks, names, logos, and commercial symbols to be used by the franchisee to identify the franchised business. It does not include every trademark owned by the franchisor.

(2) For each principal trademark, disclose whether the trademark is registered with the United States Patent and Trademark Office.

(i) For each registration, state:

(A) The date and identification number of each trademark registration or registration application;

(B) Whether the franchisor has filed all required affidavits;

(C) Whether any registration has been renewed; and

(D) Whether the principal trademarks are registered on the Principal or Supplemental Register of the U.S. Patent and Trademark Office, and if not, whether an "intent to use" application or an application based on actual use has been filed with the U.S. Patent and Trademark Office.

(ii) If the trademark is not registered on the Principal Register of the U.S. Patent and Trademark Office, state: "By not having a Principal Register federal registration for [name or description of symbol], [name of franchisor] does not have certain presumptive legal rights granted by a registration."

(3) Disclose any currently effective material determinations of the U.S. Patent and Trademark Office, the Trademark Trial and Appeal Board, or the trademark administrator of any State or court; and any pending infringement, opposition, or cancellation proceeding. Include

infringement, opposition, or cancellation proceedings in which the franchisor unsuccessfully sought to prevent registration of a trademark in order to protect a trademark licensed by the franchisor. Describe how the determination affects the franchised business.

(4) Disclose any pending material federal or State litigation regarding the franchisor's use or ownership rights in a trademark. For each pending action, disclose:[291]

(i) The forum and case number;

(ii) The nature of claims made opposing the franchisor's use or by the franchisor opposing another person's use; and

(iii) Any effective court or administrative agency ruling concerning the matter.

(5) Disclose agreements currently in effect that significantly limit the rights of the franchisor to use or license the use of trademarks listed in this Item in a manner material to the franchise. For each agreement, disclose:

(i) The manner and extent of the limitation or grant;

(ii) The extent to which the franchisee may be affected by the agreement;

(iii) The agreement's duration;

(iv) The parties to the agreement;

(v) The circumstances under which the agreement may be canceled or modified; and

(vi) All other material terms.

(6) Disclose whether the franchisor must protect the franchisee's right to use the principal trademarks listed in this Item, and must protect the franchisee against claims of infringement or unfair competition arising out of the franchisee's use of the trademarks. Disclose further:

(i) The franchisee's obligation to notify the franchisor of the use of, or claims of rights to, a trademark identical to or confusingly similar to a trademark licensed to the franchisee;

(ii) Whether the franchise agreement requires the franchisor to take affirmative action when notified of these uses or claims. Identify who has the right to control administrative proceedings or litigation;

(iii) Whether the franchise agreement requires the franchisor to participate in the franchisee's defense and/or indemnify the franchisee for expenses or damages if the franchisee is a party to an administrative or judicial proceeding involving a trademark licensed by the franchisor to the franchisee, or if the proceeding is resolved unfavorably to the franchisee; and

(iv) The franchisee's rights under the franchise agreement if the franchisor requires the franchisee to modify or discontinue the use of a trademark.

(7) Disclose whether the franchisor actually knows of either superior prior rights or infringing uses that could materially affect the franchisee's use of the principal trademarks in the State in which the franchised business is to be located. For each use of a principal trademark that the franchisor believes constitutes an infringement that could materially affect the franchisee's use of a trademark, disclose:

(i) The nature of the infringement;

(ii) The location(s) where the infringement is occurring;

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[291] Franchisors may include a summary opinion of counsel concerning any action if a consent to use the summary opinion is included as part of the disclosure document.

(iii) The length of time of the infringement (to the extent known); and

(iv) Action taken by the franchisor.

(n) ***Item 14: Patents, Copyrights, and Proprietary Information.***

(1) Disclose whether the franchisor owns rights in patents or copyrights that are material to the franchise. For each patent or copyright:

(i) Describe the patent or copyright and its relationship to the franchise;

(ii) State the duration of the patent or copyright;

(iii) For copyrights, state:

(A) The registration number and date of each copyright; and.

(B) Whether the franchisor can and intends to renew the copyright.

(iv) For patents, state:

(A) The patent number, issue date, and title for each patent, and the serial number, filing date, and title of each patent application; and

(B) Describe the type of patent or patent application (*e.g.*, mechanical, process, or design).

(2) Describe any current material determination of the U.S. Patent and Trademark Office, the U.S. Copyright Office, or a court regarding the patent or copyright. Include the forum and case number. Describe how the determination affects the franchised business.

(3) State the forum, case number, claims asserted, issues involved, and effective determinations for any material proceeding pending in the U.S. Patent and Trademark Office or the U.S. Court of Appeals for the Federal Circuit.[292]

(4) If an agreement limits the use of the patent, patent application, or copyright, state the parties to and duration of the agreement, the extent to which the franchisee may be affected by the agreement, and other material terms of the agreement.

(5) Disclose the franchisor's obligation to protect the patent, patent application, or copyright and to defend the franchisee against claims arising from the franchisee's use of the patented or copyrighted items. Disclose further:

(i) Whether the franchisee must notify the franchisor of claims or infringements or if the action is discretionary;

(ii) Whether the franchise agreement requires the franchisor to take affirmative action when notified of infringement. Disclose who has the right to control litigation;

(iii) Whether the franchisor must participate in the defense of a franchisee or indemnify the franchisee for expenses or damages in a proceeding involving a patent, patent application, or copyright licensed to the franchisee;

(iv) Requirements that the franchisee modify or discontinue use of the subject matter covered by the patent or copyright; and

(v) The franchisee's rights under the franchise agreement if the franchisor requires the franchisee to modify or discontinue use of the subject matter covered by the patent or copyright.

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[292] Franchisors may include a summary opinion of counsel concerning any action if a consent to use the summary opinion is included as part of the disclosure document.

(6) If the franchisor actually knows of an infringement that could materially affect the franchisee, disclose:

(i) The nature of the infringement;

(ii) The location(s) where the infringement is occurring;

(iii) The length of time of the infringement; and

(iv) Action taken or anticipated by the franchisor.

(7) If the franchisor claims proprietary rights in other confidential information or trade secrets, describe in general terms the proprietary information communicated to the franchisee and the terms and conditions for use by the franchisee. The franchisor need only describe the general nature of the proprietary information, such as whether a formula or recipe is considered to be a trade secret.

(o) ***Item 15: Obligation to Participate in the Actual Operation of the Franchise Business.***

(1) Disclose the franchisee's obligation to participate personally in the direct operation of the franchise business and whether the franchisor recommends participation. Include obligations arising from any written agreement or from the franchisor's practice.

(2) If personal "on-premises" supervision is not required, disclose the following:

(i) If the franchisee is an individual, state:

(A) Whether the franchisor recommends on-premises supervision by the franchisee;

(B) Limitations on whom the franchisee can hire as an on-premises supervisor, and

(C) Whether an on-premises supervisor must successfully complete the franchisor's training program.

(ii) If the franchisee is a business entity, state the amount of equity interest that the on-premises supervisor must have in the franchise.

(3) Disclose any restrictions that the franchisee must place on its manager (*e.g.*, maintain trade secrets, covenants not to compete).

(p) ***Item 16: Restrictions on What the Franchisee May Sell.*** Disclose any franchisor-imposed restrictions or conditions on the goods or services that the franchisee may sell or that limit the franchisee's customers. Disclose further:

(1) Any obligation on the franchisee to sell only goods and services approved by the franchisor;

(2) Any obligation on the franchisee to sell all goods and services authorized by the franchisor;

(3) Whether the franchisor has the right to change the types of authorized goods and services and whether there are limits on the franchisor's right to make changes; and

(4) Any restrictions on the franchisee's customers.

(q) ***Item 17: Renewal, Termination, Transfer, and Dispute Resolution.*** Disclose, in the tabular form shown below, a table that cross-references each enumerated franchise relationship item with the applicable provision in the franchise or related agreement. Summarize briefly each contractual provision. If a particular item is not applicable, state "Not Applicable." If the agreement is silent concerning one of the listed provisions, but the franchisor unilaterally offers to provide certain benefits or protections to franchisees as a matter of policy, use a footnote to describe this policy and state whether the policy is subject to change.

This table lists certain important provisions of the franchise and related agreements. You should read these provisions in the agreements attached to this disclosure document.

Provision	Section in franchise or other agreement	Summary
a. Length of the franchise term		
b. Renewal or extension of the term		
c. Requirements for franchisee to renew or extend		
d. Termination by franchisee		
e. Termination by franchisor without cause		
f. Termination by franchisor with cause		
g. "Cause" defined - curable defaults		
h. "Cause" defined - noncurable defaults		
i. Franchisee's obligations on termination/non-renewal		

j. Assignment of contract by franchisor		
k. “Transfer” by franchisee - defined		
l. Franchisor approval of transfer by franchisee		
m. Conditions for franchisor approval of transfer		
n. Franchisor’s right of first refusal to acquire franchisee’s business		
o. Franchisor’s option to purchase franchisee’s business		
p. Death or disability of franchisee		
q. Non-competition covenants during the term of the franchise		
r. Non-competition covenants after the franchise is terminated or expires		
s. Modification of the agreement		
t. Integration/merger clause		
u. Dispute resolution by arbitration or mediation		
v. Choice of forum		
w. Choice of law		

(r) ***Item 18: Public Figures.*** Disclose the following information about any public figures involved in the franchise. A public figure means a person whose name or physical appearance is generally known to the public in the geographic area where the franchise will be located.

(1) Any compensation paid or promised to a public figure arising from either the use of the public figure in the franchise name or symbol; or the endorsement or recommendation of the franchise to prospective franchisees.

(2) The extent to which the public figure is involved in the actual management or control of the franchisor. Describe the public figure's position and duties in the franchisor's business structure.

(3) The total investment of the public figure in the franchisor. Describe the extent of the amount contributed in services performed or to be performed. State the type of investment (*e.g.*, common stock, promissory note).

(s) ***Item 19: Financial Performance Representations.***

(1) All franchisors begin by stating:

> The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only where: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor provides financial performance information in Item 19 and supplements that information by providing, for example, information about possible performance at a particular location.

(2) If a franchisor does not provide any financial performance representations, also state:

> This franchisor does not make any representations about a franchisee's financial performance. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you receive any financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name and address of person to be notified], the Federal Trade Commission, and the appropriate State regulatory agencies.

(3) If the franchisor makes any financial performance representations to prospective franchisees, the franchisor must have a reasonable basis and written substantiation for the representations at the time they are made, and must state the representations in its Item 19 disclosure. The franchisor must also disclose the following:

(i) Whether the representation is an historical financial performance representation about the franchise system's existing outlets,[293] or a subset of those outlets, or is a forecast of the prospective franchisee's future financial performance.[294]

(ii) If the representation relates to the past performance of the franchise system's existing outlets, disclose the material bases for the representation, including:

(A) Whether the representation relates to the performance of all of the franchise system's existing outlets or only to a subset of outlets that share a particular set of characteristics (*e.g.*, geographic location, type of location (such as free standing vs. shopping center), degree of competition in the market area, length of time the outlets have been in operation, services or goods sold, services supplied by the franchisor, and whether the units are franchised or franchisor-owned or operated);

(B) The dates during which the reported level of financial performance was achieved;

(C) The total number of outlets that existed in the relevant period and, if different, the number of outlets that had the described characteristics;

(D) The number of outlets with the described characteristics whose actual financial performance data were utilized in arriving at the representation;

(E) Of those outlets whose data were utilized in arriving at the representation, the number and percent that actually attained or surpassed the stated results;[295] and

(F) Characteristics of the included outlets, such as those noted in subsection (3)(i) above, that may differ materially from those of the outlet that may be offered to a prospective franchisee.

(iii) If the representation is a forecast of future financial performance, state the material bases and assumptions on which the projection is based. The material assumptions underlying a forecast include significant factors upon which a franchisee's future results are expected to depend. These factors include, for example, economic or market conditions that are basic to a franchisee's operation, and encompass matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses;

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[293] If a financial performance representation is a representation concerning historical financial performance or if historical financial performance data are used as the basis for a forecast of future earnings, the historical data must be prepared according to U.S. generally accepted accounting principles.

[294] A statement or prediction of future performance that is prepared as a forecast in accordance with the statement on standards for accountants' services on prospective financial information (or its successor) issued by the American Institute of Certified Public Accountants, Inc., is presumed to have a reasonable basis.

[295] An historical financial performance representation will have a reasonable basis if it is representative of the usual experience of the system's outlets or a subset of those outlets that share specified characteristics. A representation would not have a reasonable basis if, for example, only a small minority of the stated set of franchisees earn such an amount, if profits were due to non-recurring conditions, or if the franchisees used inconsistent systems for reporting financial performance information.

(iv) Include a conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation; and

(v) State that written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.[296]

(4) If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it is not required to comply with this section, provided the information is given only to potential purchasers of that outlet and is accompanied by the name and last known address of each owner of the outlet during the prior three years.

(5) If financial performance representations are provided in Item 19, the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. The supplemental representation must:

(i) be in writing;

(ii) explain the departure from the financial performance representation in the disclosure document;

(iii) be prepared in accordance with the requirement set forth above in subsections (3)(i)-(iii); and

(iv) be left with the prospective franchisee.

(t) ***Item 20: Outlets and Franchisee Information.***

(1) Disclose, in the tabular form shown below, the status of franchised outlets by State for each of the franchisor's last three fiscal years. For purposes of this Item, "outlets" includes outlets of a type substantially similar to that offered to the prospective franchisee. A sample Item 20(1) Table is attached as Appendix B.

[296] Franchisors must possess written substantiation for any financial performance representations and must make this substantiation available to prospective franchisees and the Commission upon reasonable request. The franchisor may impose reasonable time and place limitations, and may restrict copying of documents. However, restrictions that as a practical matter frustrate a franchisee's ability to review the franchisor's financial performance information will be deemed to violate the Rule. *See* Section 436.10(c) (prohibition on failing to make information available). In order to protect franchisees from unwarranted disclosure of sensitive financial information, the franchisor may delete information that might identify the franchisee. This limitation, however, does not apply to disclosures made to the Commission.

Franchised Outlets Summary
For Years [YR-3 - YR-1**]**

(1) State and Year	(2) Outlets at Beginning of Fiscal Year	(3) Outlets With Same Ownership at End of Fiscal Year	(4) Outlets Terminated by Franchisor During the Fiscal Year	(5) Outlets Reacquired by Franchisor During the Fiscal Year	(6) Outlets Transferred by Franchisee to New Owner During the Fiscal Year	(7) Outlets That Were Not Renewed During the Fiscal Year	(8) Outlets That Ceased Operation or Closed for Other Reasons During the Fiscal Year	(9) Total Number of Outlets Discontinued During the Fiscal Year	(10) Total Outlets in Operation at End of Fiscal Year
State YR-1 YR-2 YR-3									
Totals YR-1 YR-2 YR-3									

(i) In column (1), list each State where one or more franchised outlets are located. Below each State, list each of the last three fiscal years.

(ii) In column (2), disclose the number of outlets in each State in operation at the beginning of each fiscal year.

(iii) In column (3), disclose the number of outlets in each State where the controlling ownership of the outlet did not change during the year.

(iv) In column (4), disclose the number of outlets in each State where the franchisee operating the outlet at the beginning of the fiscal year did not operate the outlet at the end of the fiscal year because the franchisor terminated or canceled the franchise agreement without providing any consideration to the franchisee (whether by payment or forgiveness or assumption of debt) before the end of the agreement term. For purposes of this Item, a termination or cancellation occurs when the franchisor sends the franchisee an unconditional notice of intent to exercise its right to terminate or cancel the franchise agreement.

(v) In column (5), disclose the number of outlets in each State where the franchisee operating the outlet at the beginning of the fiscal year did not operate the outlet at the end of the fiscal year because the franchisor reacquired the outlet for consideration (whether by payment or forgiveness or assumption of debt) from that franchisee before the end of the agreement term.

(vi) In column (6), disclose the number of outlets in each State where the franchisee operating the outlet at the beginning of the fiscal year did not operate the outlet at the end of the

fiscal year because that franchisee transferred controlling interest in the franchise to one or more new owners, other than the franchisor or an affiliate, before the end of the agreement term.

(vii) In column (7), disclose the number of outlets in each State where the franchisee operating the outlet at the beginning of the fiscal year did not operate the outlet at the end of the fiscal year because the franchise agreement was not renewed at the end of its term. For purposes of this Item, a nonrenewal occurs when the franchisor sends the franchisee an unconditional notice of intent to exercise its right not to renew the franchise agreement after it expires.

(viii) In column (8), disclose the number of outlets in each State where the franchisee operating the outlet at the beginning of the fiscal year did not operate the outlet at the end of the fiscal year for reasons other than termination, reacquisition, transfer, or post-term non-renewal (include here outlets that are still owned by the franchisee operating the outlet at the beginning of the fiscal year, but which have ceased to do business under the franchise agreement).

(ix) In column (9), disclose the total number of outlets in the State where a franchisee operating an outlet at the beginning of the year did not continue to operate the outlet at the end of the fiscal year. This figure should be the sum of the figures in columns (4) through (8).

(x) In column (10), disclose the number of outlets in each State in operation at the end of the fiscal year.

(xi) Report the ownership status of each outlet only once. The sum of columns (3) and (9) should equal the number of outlets at the beginning of the fiscal year (column 2). If an outlet is involved in more than one ownership change in a given fiscal year, report only the change in ownership by the franchisee operating the outlet at the beginning of the year. If the change in ownership of an outlet could be reported in more than one category, report only the event that occurred first chronologically.

(2) Disclose, in the tabular form shown below, a table showing the status of franchisor-owned outlets by State for each of the franchisor's last three fiscal years. A sample Item 20(2) Table is attached as Appendix C.

Franchisor-Owned Outlets Summary
for [YR-3 - YR-1**]**

(1) State and Year	(2) Outlets Operating at the Beginning of the Fiscal Year	(3) Outlets Opened During the Fiscal Year	(4) Outlets Closed During the Fiscal Year	(5) Total Number of Outlets at the End of the Fiscal Year
State YR-1 YR-2 YR-3				
Totals YR-1 YR-2 YR-3				

(i) In column (1), list each State where one or more franchisor-owned outlets are located. Below each State, list each of the last three fiscal years.

(ii) In column (2), disclose the number of franchisor-owned outlets in each State operating at the beginning of each fiscal year.

(iii) In column (3), disclose the number of franchisor-owned outlets opened in each State during each fiscal year.

(iv) In column (4), disclose the number of franchisor-owned outlets closed in each State during each fiscal year.

(v) In column (5), disclose the number of franchisor-owned outlets in operation in each State at the end of each fiscal year.

(3) Disclose, in the tabular form shown below, an estimate for each applicable State that reflects the number of franchised and franchisor-owned outlets to be opened during the one-year period after the close of the franchisor's most recent fiscal year. A sample Item 20(3) Table is attached as Appendix D.

Projected Openings
As of [Close of Fiscal Year]

(1) State	(2) Franchise Agreements Signed But Outlet Not Open	(3) Projected Franchised Outlets in the Next Fiscal Year	(4) Projected Franchisor-Owned Outlets in the Next Fiscal Year
TOTALS			

(i) In column (1), list each State where the franchisor has signed a franchise agreement, but the outlet is not yet opened, as well as each State where the franchisor expects to open a new outlet (franchisor-owned or franchised) in the next fiscal year.

(ii) In column (2), disclose the number of franchise agreements signed in each State where the outlet is not yet opened.

(iii) In column (3), disclose the projected number of new franchised outlets in each State in the next fiscal year.

(iv) In column (4), disclose the projected number of new franchisor-owned outlets in the next fiscal year.

(4) Disclose the names of all current franchisees and the address and telephone number of each of their outlets. In the alternative, the franchisor may disclose all franchised outlets in the State, but if these franchised outlets total fewer than 100, disclose franchised outlets from contiguous States and then the next closest State(s) until at least 100 franchised outlets are listed.

(5) Disclose the name and last known home address and telephone number of every franchisee who has had an outlet terminated, canceled, not renewed, or otherwise voluntarily or involuntarily ceased to do business under the franchise agreement during the most recently completed fiscal year or who has not communicated with the franchisor within 10 weeks of the disclosure document issuance date.

(6) If franchisees have signed gag clauses in a franchise agreement, settlement, or in any other contract, during the last three fiscal years:

(i) State: “In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of franchise system]. While we encourage you to speak with current and former franchisees, be aware that not all such franchisees will be able to communicate with you.”

(ii) Franchisors may also disclose the number and percentage of current and former franchisees who during each of the last three fiscal years have signed agreements that include gag clauses and may disclose the circumstances under which such clauses were signed.

(7) Disclose the name, address, and telephone number of each trademark-specific franchisee organization associated with the franchise system being offered, if such organization:

(i) Has been created, supported, or recognized by the franchisor; or

(ii) Is incorporated and asks the franchisor to be included in the franchisor's disclosure document during the next fiscal year. All such organizations must renew their request for inclusion in disclosure documents on an annual basis. The franchisor has no obligation to verify the organization's continued existence during or at the end of each fiscal year.

(u) ***Item 21: Financial Statements.***

(1) Include the following financial statements prepared according to generally accepted United States accounting principles. Except as provided in subsection (2) below, these financial statements must be audited by an independent certified public accountant. Present the required financial statements in a tabular form that compares at least two fiscal years.

(i) ***Financial statements***: The franchisor's balance sheet for the previous two fiscal year-ends before the disclosure document issuance date. In addition, include statements of operations, of stockholders equity, and of cash flows for each of the franchisor's previous three fiscal years.

(ii) ***Affiliated company statements***: Instead of the disclosure required by Item 21(1)(i), the franchisor may include financial statements of its affiliated company if the affiliated company's financial statements satisfy Item 21(1)(i) and the affiliated company absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement. The affiliate's guarantee must cover all of the franchisor's obligations to the franchisee, but is not required to extend to third parties. If this alternative is used, disclose the existence of a guarantee.

(iii) ***Consolidated and separate statements***:

(A) When a franchisor owns a direct or beneficial controlling financial interest in another corporation, its financial statements should reflect the financial condition of the franchisor and its subsidiaries.

(B) Include separate financial statements for the franchisor and any subfranchisor or comparable entity.

(C) Include separate financial statements for a company controlling 80 percent or more of a franchisor.

(2) To the extent that start-up franchise systems do not yet have audited financial statements, they may phase-in the use of audited financial statements according to the following schedule:

If this is the franchisor's:	The following financial statements included in the franchisor's disclosure document must be audited:
First partial or full fiscal year selling franchises.	None.
Second fiscal year selling franchises.	Balance sheet opinion as of the end of the last fiscal year.

Third and subsequent fiscal years selling franchises.	All required financial statements for the previous fiscal year, plus any previously disclosed audited statements that still must be disclosed according to Item 21(1)(i).

(i) Audited financial statements shall be prepared as soon as practicable.

(ii) Unaudited statements should be in a format that conforms as closely as possible to audited statements.

(iii) Disclose clearly and conspicuously in Item 21 the following, if applicable:

(A) The franchisor has not been in business for three years or more, and cannot include all of the financial statements required in section 21(1)(i); or

(B) The franchisor includes one or more years of unaudited financial statements.

(iv) In the event a start-up franchise system begins offering franchises before the close of its first full fiscal year of operations, provide at a minimum the company's unaudited opening balance sheet.

(v) ***Item 22: Contracts.*** Attach a copy of all proposed agreements regarding the franchise offering, including the franchise agreement and any lease, options, and purchase agreements.

(w) ***Item 23: Receipt.***

(1) Include the following detachable acknowledgment of receipt in the form set out below.

(i) State the following:

This disclosure document summarizes certain provisions of the franchise agreement and other information in plain language. Read this disclosure document and all agreements carefully.

If [name of franchisor] offers you a franchise, it must provide this disclosure document to you 14 days before the earlier of:

(1) the signing of a binding agreement; or
(2) any payment to [name of franchisor or affiliate].

You must also receive a franchise agreement containing all material terms at least five days before you sign a franchise agreement.

If [name of franchisor] does not deliver this disclosure document on time or if it contains a false or misleading statement, or a material omission, a violation of federal law and State law may have occurred and should be reported to the Federal Trade Commission, Washington, D.C. 20580 and [State agency].

(ii) Disclose the name, principal business address, and telephone number of any subfranchisor or franchise broker offering the franchise.

(iii) State the issuance date.

(iv) If not disclosed in Item 1, state the name and address of the franchisor's registered agent authorized to receive service of process.

(v) Provide the following statement:

I have received a disclosure document dated _____ that included the following Exhibits:"

(vi) List the title of all attached Exhibits.

(vii) Provide a space for the franchisee's signature and date.

(viii) Franchisors may include any specific instructions for returning the receipt (*e.g.*, street address, E-mail address, facsimile telephone number).

(2) Franchisors shall obtain a signed copy of the receipt at least 5 days before the franchise agreement is signed or the prospective franchisee pays any fee in connection with the franchise sale.

(3) For each completed franchise sale, franchisors shall retain a copy of the signed receipt for a period of at least 3 years.

INSTRUCTIONS

§ 436.6 Instructions for Preparing Disclosure Documents

(a) Disclose the information required in sections 436.3 - 436.5 clearly, legibly, and concisely stated in a single document, using plain English.

(b) Respond fully to each disclosure Item. If a particular disclosure Item is not applicable, respond negatively, including a reference to the type of information required to be disclosed by the Item. Precede each disclosure Item with the appropriate heading.

(c) Do not include any materials or information other than that required by this Rule or by State law not preempted by this Rule. Franchisors may prepare multi-State disclosure documents by including State-specific information in the text of the disclosure document or in Exhibits attached to the disclosure document.

(d) Subfranchisors should disclose the required information about the franchisor, and, to the extent applicable, the same information concerning the subfranchisor.

§ 436.7 Instructions For Electronic Disclosure Documents. Franchise sellers can furnish disclosures electronically under the following conditions:

(a) The prospective franchisee expressly consents to accept the disclosures in the electronic medium offered by the franchise seller. Prospective franchisees, however, always

retain the right to obtain a paper disclosure document from the franchise seller up until the time of the sale.

(b) The franchise seller simultaneously furnishes the prospective franchisee with a paper summary document containing only the following three items from the franchisor's disclosure document:

(1) The cover page;

(2) The table of contents; and

(3) Two copies of the franchisor's Item 23 Receipt, with instructions to acknowledge receipt through a signature.

(c) The electronic version of the franchisor's disclosure document must be capable of being printed, downloaded onto computer disk, or otherwise preserved by a prospective franchisee as one single document.

(d) The electronic version of the franchisor's disclosure document must be a self-contained document that is the functional equivalent of a paper disclosure document. A prospective franchisee must be able to read each part of the disclosure document, including attachments, without having to take any affirmative action other than scrolling through the document.

(e) For the sole purpose of enhancing the prospective franchisee's ability to maneuver through the electronic version of the disclosure document, the franchisor may include scroll bars, internal links, and search features. All other features (*e.g.*, multimedia tools such as audio, video, animation, or pop-up screens) are prohibited.

(f) The electronic version of the franchisor's disclosure document must remain accessible at least until the time of the sale. An electronic version will still be deemed accessible if technological failures occur that are beyond the franchisor's reasonable control. Further, an electronic version on the Internet will be deemed accessible if it is updated and replaced with a more current version.

(g) Franchisors furnishing disclosure documents electronically must retain, and make available to the Commission upon request, a specimen copy of each materially different version of their electronic disclosure documents for a period of three years.

§ 436.8 Instructions For Updating Disclosures

(a) All information contained in the disclosure document shall be current as of the close of the franchisor's most recent fiscal year. After the close of the fiscal year, the franchisor shall, within 90 days, prepare a revised disclosure document, after which the franchisor may distribute only the revised document and no other.

(b) The franchisor shall, within a reasonable time after the close of each quarter of the fiscal year, prepare revisions to be attached to the disclosure document to reflect any material change in the franchisor or relating to the franchise business of the franchisor. Each prospective franchisee shall receive the disclosure document and the quarterly revisions for the most recent period available at the time.

(c) When furnishing a disclosure document, the franchise seller shall notify the prospective franchisee of any additional material change in the franchisor, the franchise business, or franchise agreement that has occurred since the last quarterly disclosure document revision. Franchise sellers shall also notify the prospective franchisee of any other known material change in the franchisor, the franchise business, or franchisee agreement at the time the completed franchise agreements are delivered to the prospective franchisee pursuant to section 436.2(a)(2).

(d) Information that is required to be audited pursuant to Item 21 is not required to be audited for quarterly revisions; provided, however, that the franchisor states in immediate conjunction with the information that such information has not been audited.

OTHER PROVISIONS

§ 436.9 Exemptions. The disclosure requirements of sections 436.2 - 436.8 of this Rule shall not apply if the franchisor can establish any of the following:

(a) The total of the required payments to the franchisor or an affiliate that are made any time before to within six months after commencing operation of the franchisee's business is less than $500, not including payment for the purchase of reasonable amounts of inventory at *bona fide* wholesale prices for resale.

(b) The franchise relationship is a fractional franchise.

(c) The franchise relationship is a leased department.

(d) The franchise relationship is covered by the Petroleum Marketing Practices Act, 15 U.S.C. 2801.

(e)(1) The franchisee's estimated investment, excluding any financing received from the franchisor or an affiliate, totals at least $1.5 million and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption; or (2) the franchisee is a corporation that has been in business for at least five years and has a net worth of at least $5 million. Provided, however, that the Commission may publish revised thresholds once every four years to adjust for inflation.

(f) One or more purchasers of at least a 50 percent ownership interest in the franchise are, or have been within 60 days of the sale, an officer, director, managing agent, or an owner of at least a 25 percent interest in the franchisor, for at least 24 months.

(g) There is no written document that describes any material term or aspect of the relationship or arrangement.

§ 436.10 ADDITIONAL PROHIBITIONS. It is an unfair or deceptive act or practice in violation of section 5 of the Federal Trade Commission Act for any franchise seller to:

(a) Make any claim or representation, orally, visually, or in writing, that contradicts the information required to be disclosed by this Rule.

(b) Fail to return any funds or deposits in accordance with any conditions disclosed in the franchisor's disclosure document, franchise agreement, or related document.

(c) Fail to make available to prospective franchisees, and to the Commission upon reasonable request, written substantiation for any financial performance representations made in Item 19, above.

(d) Disseminate any financial performance representation to prospective franchisees, including any representations made in the general media and Internet, unless the franchise seller has a reasonable basis for the representation, has written substantiation for the claim at the time the claim is made, and the representation is included in Item 19 of the franchisor's disclosure document. In conjunction with any such financial performance representation, the franchise seller shall also:

(1) Disclose the information required by Item 19(3)(ii)(E) if the representation relates to the past performance of the franchisor's outlets; and

(2) Include a conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation.

(e) Disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or its exhibits or amendments. Provided, however, that a prospective franchisee can agree to contractual terms and conditions that differ from those specified in a disclosure document if: (1) the franchise seller identifies the changed terms and conditions; (2) the prospective franchisee initials the changes; and (3) the prospective franchisee has 5 days before signing the contract or paying any fee to review the revised contract.

(f) Misrepresent that any person:

(1) Has purchased a franchise from the franchisor or operated a franchise of the type offered by the franchisor; or

(2) Is able to provide an independent and reliable report about the franchise or the experiences of any current or former franchisees.

§ 436.11 OTHER LAWS, RULES, ORDERS.

(a) The Commission does not approve or otherwise express any opinion on the legality of any matter a franchisor may be required to disclose by this Rule. Further, franchisors may have other obligations to disclose material information to prospective franchisees under section 5 of the Federal Trade Commission Act. The Commission also intends to enforce all applicable statutes and trade regulation rules.

(b) If an outstanding FTC order applies to a franchisor but differs from any provision of this regulation, the franchisor can petition the Commission to amend the order.

(c) The FTC does not intend to preempt the franchise practices laws of any State or local government, except to the extent of any inconsistency with this Rule. A law is not inconsistent with this Rule if it affords prospective franchisees equal or greater protection, such as registration of disclosure documents or more extensive disclosures.

§ 436.12 SEVERABILITY.

If any provision of this regulation is stayed or held invalid, the remainder will stay in force.

By direction of the Commission.

Donald S. Clark,
Secretary.

Appendix A: Sample Item 10 Table

Summary Of Financing Offered

Item Financed	Amount Financed	Down Payment	Term (YRS)	APR %	Monthly Payment	Prepay Penalty	Security Required	Liability Upon Default	Loss of Legal Rights on Default
Initial fee									
Land/ Constr.									
Leased space									
Equip. Lease									
Equip. Purchase									
Opening inventory									
Other financing									

Appendix B: Sample Item 20(1) Table

Franchised Outlet Summary
For Years 1995-1997

(1) State and Year	(2) Outlets at Beginning of Fiscal Year	(3) Outlets With Same Ownership At End of Fiscal Year	(4) Outlets Terminated by Franchisor During the Fiscal Year	(5) Outlets Reacquired by Franchisor During the Fiscal Year	(6) Outlets Transferred by Franchisee to New Owner During the Fiscal Year	(7) Outlets that Were Not Renewed During the Fiscal Year	(8) Outlets that Ceased Operation or Closed for Other Reasons During the Fiscal Year	(9) Total Number of Outlets Discontinued During the Fiscal Year	(10) Total Outlets in Operation at End of Fiscal Year
AL									
1997	2	1	1	0	0	0	0	1	1
1996	2	2	0	0	0	0	0	0	2
1995	1	1	0	0	0	0	0	0	2
MI									
1997	4	3	1	0	0	0	0	1	4
1996	7	4	0	0	2	1	0	3	4
1995	8	6	0	1	0	0	1	2	7
WY									
1997	3	2	0	0	0	0	1	1	2
1996	1	1	0	0	0	0	0	0	3
1995	0	0	0	0	0	0	0	0	1
TOTALS									
1997	9	6	2	0	0	0	1	3	7
1996	10	7	0	0	2	1	0	3	9
1995	9	7	0	1	0	0	1	2	10

Appendix C: Sample Item 20(2) Table

Franchisor-Owned Outlets Summary
for 1995-1997

(1) State and Year	(2) Outlets Operating at the Beginning of the Fiscal Year	(3) Outlets Opened During the Fiscal Year	(4) Outlets Closed During the Fiscal Year	(5) Total Number of Outlets at the End of the Fiscal Year
AL				
1997	5	0	0	5
1996	3	2	0	5
1995	4	2	3	3
MI				
1997	4	1	0	5
1996	6	0	2	4
1995	5	2	1	6
WY				
1997	1	0	0	1
1996	0	2	1	1
1995	0	0	0	0
TOTALS				
1997	10	1	0	11
1996	9	4	3	10
1995	9	4	4	9

Appendix D: Sample Item 20(3) Table

Projected Openings
As of December 31, 1997

(1) State	(2) Franchise Agreements Signed But Outlet Not Open	(3) Projected Franchised Outlets in the Next Fiscal Year	(4) Projected Franchisor-Owned Outlets in the Next Fiscal Year
AL	1	1	0
MI	0	3	2
WY	1	0	0
TOTALS	2	4	2

NPR ATTACHMENT A
TABLE OF COMMENTERS

Comment 1. Kevin Brendan Murphy, Esq., Mr. Franchise ("Murphy")
Comment 2. Murphy (*see supra*, Comment 1)
Comment 3. Mike Bruce, The Michael Bruce Fund ("Bruce")
Comment 4. Harold Brown, Esq., Brown & Stadfeld ("Brown")
Comment 5. Frances L. Diaz, Esq. ("Diaz")
Comment 6. Brown (*see supra*, Comment 4)
Comment 7. Diaz (*see supra*, Comment 5)
Comment 8. Marian Kunihisa ("Kunihisa")
Comment 9. Kevin Bores, Domino's Pizza Franchisee ("Bores")
Comment 10. Terrence L. Packer, Supercuts Franchisee ("Packer")
Comment 11. John Delasandro ("Delasandro")
Comment 12. William Cory ("Cory")
Comment 13. Joseph Manuszak, Domino's Pizza Franchisee ("Manuszak")
Comment 14. Daryl Donafin, Taco Bell Franchisee ("Donafin")
Comment 15. David Muncie, National Claims Service, Inc. ("Muncie")
Comment 16. Patrick E. Meyers, The Quizno's Corporation ("Quizno's")
Comment 17. David Weaver, Domino's Pizza Franchisee ("Weaver")
Comment 18 Karen M. Paquet, Domino's Pizza Franchisee ("Paquet")
Comment 19. Gary R. Duvall, Esq., Graham & Dunn ("Duvall")
Comment 20. Andrew J. Sherman, Esq., Greenberg & Traurig ("Sherman")
Comment 21. S. Beavis Stubbings, Esq. ("Stubbings")
Comment 22. Jim & Evalena Gray, Pearle Vision Franchisee ("J&E Gray")
Comment 23. Ernest Higginbotham, et al., Strasburger & Price ("Higginbotham")
Comment 24. Henry C. Su, Esq., & Byron Fox, Esq. ("Su")
Comment 25. John R.F. Baer, Esq., Keck, Mahin & Cate ("Baer")
Comment 26. Clay Small, Esq., & Lowell Dixon, Esq., Nat'l Franchise Mediation Program Steering Committee ("NFMP")
Comment 27. Richard T. Catalano, Esq. ("Catalano")
Comment 28. Neil Simon, Esq., & Erik Wulff, Esq., Hogan & Hartson ("Hogan & Hartson")
Comment 29. Glenn A. Mueller, Domino's Pizza Franchisee ("Mueller")
Comment 30. Doug Bell, et al., Supercuts Franchisees ("Supercuts Franchisees")
Comment 31. Michael L. Bennett, The Longaberger Co. ("Longaberger")
Comment 32. John Rachide, Domino's Pizza Franchisee ("Rachide")
Comment 33. David J. Kaufmann, Esq., Kaufmann, Feiner, Yamin, Gildin & Robbins ("Kaufmann")
Comment 34. Joseph N. Mariano, Esq., Direct Selling Association ("DSA")
Comment 35. Linda F. Golodner & Susan Grant, National Consumers League ("NCL")
Comment 36. Jere W. Glover, Esq., & Jennifer A. Smith, Esq., U.S. Small Business Administration, Office of Chief Counsel for Advocacy ("SBA Advocacy")
Comment 37. Robert Chabot, Domino's Pizza Franchisee ("Chabot")

Comment 38. Teresa Maloney, National Coalition of Associations of 7-Eleven Franchisees ("Maloney")
Comment 39. BLANK
Comment 40. Harold L. Kestenbaum, Esq. ("Kestenbaum")
Comment 41. Samuel L. Sibent, KFC Franchisee ("Sibent")
Comment 42. Oren C. Crothers, KFC Franchisee ("Crothers")
Comment 43. Matthew Jankowski, KFC Franchisee ("Jankowski")
Comment 44. Rodney A. DeBoer, KFC Franchisee ("DeBoer")
Comment 45. Liesje Bertoldi, KFC Franchisee ("L. Bertoldi")
Comment 46. Steve Bertoldi, KFC Franchisee ("S. Bertoldi")
Comment 47. Charles Buckner, KFC Franchisee ("Buckner")
Comment 48. Walter J. Knezevich, KFC Franchisee ("Knezevich")
Comment 49. Jeffrey W. Gray, KFC Franchisee ("J. Gray")
Comment 50. Fred Jackson, KFC Franchisee ("Jackson")
Comment 51. Ronald L. Rufener, KFC Franchisee ("Rufener")
Comment 52. Tim Morris, KFC Franchisee ("Morris")
Comment 53. Scarlett Norris Adams, KFC Franchisee ("Adams")
Comment 54. Calvin G. White, KFC Franchisee ("White")
Comment 55. Nick Iuliano, KFC Franchisee ("N. Iuliano")
Comment 56. Dolores Iuliano, KFC Franchisee ("D.Iuliano")
Comment 57. Ralph A. Harman, KFC Franchisee ("R. Harman")
Comment 58. Saundra S. Harman, KFC Franchisee ("S. Harman")
Comment 59. Richard Braden, KFC Franchisee ("Braden")
Comment 60. K.F.C. of Pollys, KFC Franchisee ("Pollys")
Comment 61. Joan Fiore, McDonald's Franchisee ("Fiore")
Comment 62. Susan P. Kezios, American Franchisee Association ("AFA")
Comment 63. Kenneth R. Costello, Esq., Loeb & Loeb, LLP ("Loeb & Loeb")
Comment 64. AFA (*see supra* Comment 62)
Comment 65. Susan Rich, KFC Franchisee ("Rich")
Comment 66. Fiore (*see supra* Comment 61)
Comment 67. Mike Johnson, Subway Franchisee ("Johnson")
Comment 68. Laurie Gaither, GNC Franchisee ("L. Gaither")
Comment 69. Greg Gaither, GNC Franchisee ("G. Gaither")
Comment 70. Greg Suslovic, Subway Franchisee ("Suslovic")
Comment 71. Richard Colenda, GNC Franchisee ("Colenda")
Comment 72. Bob Gagliati, GNC Franchisee ("Gagliati")
Comment 73. Pat Orzano, 7-Eleven Franchisee ("Orzano")
Comment 74. Linda Gaither, GNC Franchisee ("Li Giather")
Comment 75. Kevin 100 ("Kevin 100")
Comment 76. Robert James, Florida Dept. of Agriculture & Consumer Services ("James")
Comment 77. Robert A. Tingler, Esq., Office of the Attorney General, State of Illinois ("IL AG")
Comment 78. John M. Tifford, Esq., Rudnick, Wolfe, Epstien & Zeidman ("Tifford")
Comment 79. Robert L. Purvin, Jr. ("Purvin")

Comment 80. Teresa Heron ("Heron")
Comment 81. Purvin (*See supra* Comment 79)
Comment 82. Matthew R. Shay, Esq., International Franchise Association ("IFA")
Comment 83. Duvall (*See supra* Comment 19)
Comment 84. Lance Winslow, Car Wash Guys ("Winslow")
Comment 85. Winslow (*See supra* Comment 84)
Comment 86. Rick Geu, The Pampered Chef, Ltd. ("Pampered Chef")
Comment 87. John M. Tifford, Esq., Coverall North America, Inc. ("Coverall")
Comment 88. John M. Tifford, Esq., Merchandise Mart Properties, Inc. ("Merchandise Mart")
Comment 89. Dirk C. Bloemendaal, Esq., Amway Corporation ("Amway")
Comment 90. Winslow (*See supra* Comment 84)
Comment 91. Winslow (*See supra* Comment 84)
Comment 92. Winslow (*See supra* Comment 84)
Comment 93. Winslow (*See supra* Comment 84)
Comment 94. Andrew A. Caffey, Esq. ("Caffey")
Comment 95. Entrepreneur Media, Inc. ("Entrepreneur")
Comment 96. Brown (*See supra* Comment 4)
Comment 97. Raymond & Robert Buckley, Scorecard Plus Franchisee ("Buckley")
Comment 98. Mark A. Kirsch, Esq., Rudnick, Wolfe, Epstien & Zeidman ("Kirsch")
Comment 99. Dale E. Cantone, Esq., Maryland Division of Securities, Office of the Maryland Attorney General ("MD Securities")
Comment 100. Roger C. Haines, Scorecard Plus Franchisee ("Haines")
Comment 101. David E. Myklebust, Scorecard Plus Franchisee ("Myklebust")
Comment 102. Robert Larson ("Larson")
Comment 103. Brown (*See supra* Comment 4)
Comment 104. Mark B. Forseth, Esq., CII Enterprises ("CII")
Comment 105. Bertrand T. Ungar, Esq., PR ONE, LLC ("PR ONE")
Comment 106. Dennis E. Wieczorek, Esq., Rudnick & Wolfe ("Wieczorek")
Comment 107. Gerald A. Marks, Esq., Marks & Krantz ("Marks")
Comment 108. Brown (*See supra* Comment 4)
Comment 109. Everett W. Knell ("Knell")
Comment 110. Anne Crews, Mary Kay, Inc. ("Mary Kay")
Comment 111. Carl Letts, Dominos Pizza Franchisee ("Letts")
Comment 112. Kat Tidd, Esq. ("Tidd")
Comment 113. Ted Poggi, National Coalition of Associations of 7-Eleven Franchisees ("NCA 7-Eleven Franchisees")
Comment 114. Gary R. Duvall, Esq., & Nadine C. Mandel, Esq. (Duvall & Mandel)
Comment 115. Sherry Christopher, Esq., Christopher Consulting, Inc. ("Christopher")
Comment 116. Carl C. Jeffers, Intel Marketing Systems, Inc. ("Jeffers")
Comment 117. Deborah Bortner, Esq., State of Washington, Department of Financial Institutions, Securities Division ("WA Securities")
Comment 118. Carmen D. Caruso, Esq., Noonan & Caruso ("Caruso")
Comment 119. Howard Bundy, Esq., Bundy & Morrill, Inc. ("Bundy")

Comment 120. Franchise & Business Opportunity Committee, North American Securities Administrators Association, Inc. ("NASAA")
Comment 121. Tifford (*See supra* Comment 78)
Comment 122. Wieczorek (*See supra* Comment 106)
Comment 123. John & Debbie Lopez, Baskin Robbins Franchisee ("Lopez")
Comment 124. Susan R. Essex, Esq., & Ted S. Storey, Esq., Business Law Section, The State Bar of California ("CA BLS")
Comment 125. Peter C. Lagarias, Esq., The Legal Solutions Group ("Lagarias")
Comment 126. Jame G. Merret, Jr. ("Merret")
Comment 127. W. Michael Garner, Esq., Dady & Garner ("Dady & Garner")
Comment 128. Jeff Brickner ("Brickner")
Comment 129. Bernard A. Brynda, Baskin Robbins Franchisee ("Brynda")
Comment 130. Caron B. Slimak, Jacadi USA Franchisee ("Slimak")
Comment 131. Dr. Ralph Geiderman, Pearl Vision Franchisee ("Geiderman")
Comment 132. Felipe Frydman, Minister, Economic & Trade Affairs, Embassy of the Argentine Republic ("Argentine Embassy")
Comment 133. Andrew C. Selden, Esq., Briggs & Morgan ("Selden")
Comment 134. Robert Zarco, Esq., et al., Zarco & Pardo ("Zarco & Pardo")
Comment 135. Jason H. Griffing, Baskin Robbins Franchisee ("Griffing")
Comment 136. Erik H. Karp, Esq., Witmer, Karp, Warner & Thuotte ("Karp")
Comment 137. William D. Brandt, Esq., Ferder, Brandt, Casebeer, Cooper, Hoyt & French ("Brandt")
Comment 138. Robert S. Keating, Baskin Robbins Franchisee ("Keating")
Comment 139. A. Patel, Baskin Robbins Franchisee ("A. Patel")
Comment 140. Joel R. Buckberg, Cendant Corporation ("Cendant")
Comment 141. Duvall (*See supra*, Comment 19)
Comment 142. NCL (*See supra,* Comment 35)
Comment 143. AFA (*See supra,* Comment 62)
Comment 144. Catalano (*See supra*, Comment 27)
Comment 145. DSA (*See supra,* Comment 34)
Comment 146. Keating, (*See supra,* Comment 139)
Comment 147. Kathie & David Leap, Baskin Robbins Franchisee ("Leap")
Comment 148. Ted D. Kuhn, Baskin Robbins Franchisee ("Kuhn")
Comment 149. Mike S. Lee, Baskin Robbins Franchisee ("Lee")
Comment 150. R. Deilal, Baskin Robbins Franchisee ("Deilal")
Comment 151. Frank J. Demotto, Baskin Robbins Franchisee ("Demotto")
Comment 152. Thomas Hung, Baskin Robbins Franchisee ("Hung")
Comment 153. Jean Jones, Baskin Robbins Franchisee ("Jones")
Comment 154. Hang, Baskin Robbins Franchisee ("Hang")
Comment 155. Dilip Patel, Baskin Robbins Franchisee ("D. Patel")
Comment 156. Terry L. Glase, Baskin Robbins Franchisee ("Glase")
Comment 157. R.E. Williamson, Baskin Robbins Franchisee ("Williamson")
Comment 158. R.M. Valum, Baskin Robbins Franchisee ("Valum")
Comment 159. Rajendra Patel, Baskin Robbins Franchisee ("R. Patel")

Comment 160. Jerry & Debbie Robinett, Baskin Robbins Franchisee (“Robinett”)
Comment 161. Ronald J. Rudolf, Baskin Robbins Franchisee (“Rudolf”)
Comment 162. Kamlesh Patel, Baskin Robbins Franchise (“K. Patel”)
Comment 163. Nicholas & Marilyn Apostal, Baskin Robbins Franchisee (“Apostal”)
Comment 164. Patrick Sitin, Baskin Robbins Franchisee (“Sitin”)
Comment 165. Paul & Lisa SeLander, Baskin Robbins Franchisee (“SeLander”)
Comment 166. S. Bhilnym, Baskin Robbins Franchisee (“Bhilnym”)
Comment 167. Mike & Kathy Denino, Baskin Robbins Franchisee (“Denino”)

NPR ATTACHMENT B
WORKSHOP CONFERENCES: PANELISTS

Michael Bennett, Esq., Longaberger Company ("Bennett")
Kennedy Brooks, Esq. ("Brooks")
John Brown, Esq., Amway Corporation ("J. Brown")
Howard Bundy, Esq., Bundy & Morrill ("Bundy")
Delia Burke, Esq., Jenkins & Gilchrist ("Burke")
Andrew Caffey, Esq. ("Caffey")
Dale Cantone, Esq., Office of the Maryland Attorney General ("Cantone")
Emilio Casillas, Washington State Securities Division ("Casillas")
Richard Catalano, Esq. ("Catalano")
Sherry Christopher, Esq. ("Christopher")
Martin Cordell, Esq., Washington State Securities Division ("Cordell")
John D'Alessandro ("D'Alessandro")
Gary Duvall, Esq., Graham & Dunn ("Duvall")
Eric Ellman, Esq., Direct Selling Association ("Ellman")
David Finnigan, Esq., Illinois Securities Department ("Finnigan")
Mark B. Forseth, Esq., Jenkens & Gilchrist ("Forseth")
Elizabeth Garceau, PRO Design ("E. Garceau")
Michael Garceau, PRO Design ("M. Garceau")
Roger Gerdes, Microsoft Corporation ("Gerdes")
Rick Geu, Esq., The Pampered Chef ("Geu")
Judy Gitterman, Esq., Jenkens & Gilchrist ("Gitterman")
Susan Grant, National Consumers League ("Grant")
Tee Houston-Aldridge, World Inspection Network ("Houston-Aldridge")
Robert James, Florida Dept. of Agriculture & Consumer Services ("James")
Carl Jeffers, Intel Marketing Systems ("Jeffers")
David Kaufmann, Esq., Kaufmann, Feiner, Yamin, Gildin & Robbins ("Kaufmann")
Harold Kestenbaum, Esq., Hollenburg, Bleven, Solomon, Ross ("Kestenbaum")
Susan Kezios, America Franchisee Association ("Kezios")
Mark Kirsch, Esq., Rudnick, Wolfe, Epstien & Zeidman ("Kirsch")
Mike Ludlum, Entrepreneur Media ("Ludlum")
Philip McKee, National Consumers League ("McKee")
Joseph Punturo, Esq., Office of the New York Attorney General ("Punturo")
Philip Sanson, Esq., Illinois Securities Department ("Sanson")
Matthew Shay, Esq., International Franchise Association ("Shay")
David Silverman, Sportsworld Int'l. ("Silverman")
Neil Simon, Esq., Hogan & Hartson ("Simon")
J. H. Snow, Esq., Jenkens & Gilchrist ("Snow")
Adam Sokol, Esq., Illinois Attorney General's Office ("Sokol")

Kat Tidd, Esq. (“Tidd”)
John Tifford, Esq., Rudnick, Wolfe, Epstien & Zeidman (“Tifford”)
Bertrand Unger, Esq., PR ONE (“Unger”)
Dick Way, PR ONE (“Way”)
Dennis Wieczorek, Esq., Rudnick & Wolfe (“Wieczorek”)
Erik Wulff, Esq., Hogan & Harston (“Wulff”)
Barry Zaslav, Coverall North America (“Zaslav”)
Michael W. Chiodo, Domino’s Franchisee (“Chiodo”)
Joseph Cristiano, Carvel Franchisee (“Cristiano”)
John D’Alessandro, Quaker State Quick Lube Distributor (“D’Alessandro”)
Mark Deutsch, Former Franchisee (“Deutsch”)
“Steve Doe,” Franchisee (“Doe”)
Debbie Fetzer (“Fetzer”)
Richard W. Galloway, Domino’s Pizza Franchisee (“Galloway”)
Bruce Hoar & Thomas Hoar, Hanes Franchisee (“Hoar”)
Nelson Hockert-Lotz, Domino’s Franchisee (“Hockert-Lotz”)
Robert L. James, Florida Dept. of Agriculture & Consumers Services (“James”)
Eric Karp, Esq., Witmer, Karp, Warner & Thuotte (“Karp”)
Susan Kezios, American Franchisee Association (“Kezios”)
Charles Lay, Brite Site Franchisee (“Lay”)
Marge Lundquist, Franchisee (“Lundquist”)
Gerald Marks, Esq., Marks & Krantz (“Marks”)
Dianne Mousley, Mike Schmidt’s Phil. Hoagies Franchisee (“Mousley”)
Mehran Rafizadeh, GNC Franchisee (“Rafizadeh”)
David W. Raymond, Esq. (“Raymond”)
Iris Sandow, Blimpie Franchisee (“Sandow”)
Caron Slimak, Jacadi Franchisee (“Slimak”)
Robert Tingler, Esq., Franchise Bureau Chief, Illinois Attorney General’s Office (“Tingler”)
Dr. Spencer Vidulich, Pearle Vision Franchisee (“Vidulich”)