FEDERAL TRADE COMMISSION

DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING

Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436)

BUREAU OF CONSUMER PROTECTION
AUGUST 2004

Disclosure Requirements and Prohibitions Concerning Franchising
Staff Report to the Federal Trade Commission and
Proposed Revised Trade Regulation Rule
(16 CFR Part 436)

Steven Toporoff
Attorney

Eileen Harrington
Associate Director
Division of Marketing Practices

J. Howard Beales, III
Director
Bureau of Consumer Protection

This Report, as required by Section 1.13(f) of the Commission's Rules of Practice, contains the staff's analysis of the rule amendment record and its recommendations as to the form of the final revised Franchise Rule. The Report has not been reviewed or adopted by the Commission. The Commission's final determination in this matter will be based upon the record taken as a whole, including the Report and comments on the Report received during the 75-day period after the Report is placed on the public record.

SUMMARY OF CHAPTERS

TABLE OF CONTENTS

Since 1995, the Commission has considered amending its trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" ("Franchise Rule" or "Rule")[1] to ensure that it continues to be relevant in today's marketplace and reflects our law enforcement experience over the last twenty years. The amendment process began with a regulatory review of the Rule in 1995, which was followed by the publication of an Advance Notice of Proposed Rulemaking ("ANPR") in 1997 and most recently by a Notice of Proposed Rulemaking ("NPR") in 1999. In general, there is substantial support for the Rule, although many commenters[2] believe that the Commission should reduce inconsistencies between federal and state pre-sale disclosure laws, update the Rule to address international franchise sales and new technologies such as the Internet, and expand the Rule's disclosures to address franchisees' concerns about the underlying franchise relationship. This report analyzes the rulemaking record to date[3] and sets forth the staff's recommendations for the final revised Rule.

---

[1] 16 C.F.R. Part 436.

[2] A list of the commenters to date, and the abbreviations used to identify each, is attached as Attachment A.

[3] References to the rulemaking record are cited as follows:

Source	Citation Format	Example
NPR Comments	[commenter], Comment [comment number]	NASAA, Comment 17
ANPR Comments	[commenter], ANPR [comment number]	NASAA, ANPR 120
ANPR Transcripts	[commenter], ANPR, [date] Tr	Bundy, ANPR, 6Nov97 Tr
Rule Review Comments	[commenter], RR [comment number]	NASAA, RR 43
Rule Review Transcripts	[commenter], RR, [Sept95 or Mar96] Tr	D'Imperio, RR, Sept95 Tr

I. BACKGROUND

In 1995, the Commission conducted a regulatory review of the Franchise Rule,[4] in which it sought public comment on whether there was a continuing need for the Rule and, if so, how to improve the Rule in light of industry changes since its promulgation in the late 1970s. In response, the Commission received 75 written comments. In addition, the Commission staff held two public workshop conferences, in which a total of fifty individuals participated. The first conference – held on September 11-13, 1995, in Bloomington, Minnesota – discussed the comments on the Rule, in particular whether the Commission should reduce inconsistencies between federal and state pre-sale disclosure law by incorporating the Uniform Franchise Offering Circular ("UFOC") Guidelines adopted by each of the fifteen states with franchise disclosure laws.[5] Participants also discussed issues arising from business opportunity sales. The second conference – held on March 11, 1996, in Washington, D.C. – discussed the Franchise Rule's application to international franchise sales.

Following the Rule Review, the Commission decided to amend the Franchise Rule and to that end published an Advance Notice of Proposed Rulemaking ("ANPR").[6] The ANPR solicited comment on several proposed Rule modifications, including creating a separate trade regulation for business opportunity sales, revising the Rule's disclosures to mirror those of the UFOC Guidelines, limiting the Rule's application to sales of franchises to be located in the United States, and permitting electronic disclosure. In response, the Commission received 166 written comments. The staff also held six public workshop conferences on the issues raised in the comments, as set forth below:[7]

---

[4] 60 Fed. Reg. 17,656 (Apr. 7, 1995).

[5] The UFOC Guidelines disclosure format is similar in many respects to the Franchise Rule's disclosure requirements. To reduce compliance costs and burdens, the Commission permits franchisors to use the UFOC Guidelines format, as long as they do so completely and accurately. *See* 60 Fed. Reg. 51,895 (Oct. 4, 1995) (authorizing states to use revised UFOC Guidelines). A copy of the UFOC Guidelines can be found at the corporate finance section of the North American Securities Administrators Association Web site: www.nasaa.org.

[6] 62 Fed. Reg. at 9,115 (Feb. 28, 1997).

[7] In general, the first day of each public workshop conference discussed specific issues announced in advance. Participants at these meetings were selected based upon their comments or interest in the subject matter. The second day of each conference was an open forum in which the public was invited to express their views on any franchise or business opportunity issue.

Conf.	Topic(s)	Location	Dates
1	Trade Show Promoters	Washington, DC	July 28-29, 1997
2	Business Opportunities	Chicago, IL	August 21-22, 1997
3	UFOC, Internet, International, Co-branding, Alternatives to Traditional Law Enforcement	New York, NY	September 18-19, 1997
4	Business Opportunities	Dallas, TX	October 20-21, 1997
5	UFOC, Internet, International, Co-branding, Alternatives to Traditional Law Enforcement	Seattle, WA	November 6-7, 1997
6	Business Opportunities	Washington, DC	November 20-21, 1997

Sixty-five individuals participated in the ANPR public workshops, including franchisees, franchisors, business opportunity sellers and their representatives, state franchise and business opportunity regulators, and computer consultants.

The next step in the rule amendment process was the publication of a Notice of Proposed Rulemaking ("NPR") in October 1999.[8] The NPR included a proposed revised Rule and a detailed discussion of each proposed Rule revision. Among other things, the NPR addressed: (1) the international application of the Rule; (2) the scope of certain existing disclosure requirements, such as the litigation and franchisee statistics disclosures; (3) new disclosures, such as those for franchisee associations; and (4) new instructions permitting disclosure via the Internet. It also proposed creating exemptions to the Rule for sophisticated prospective franchisees.

In response to the NPR, the Commission received 40 comments. Overwhelmingly, the comments supported the proposed revised Rule, albeit with fine-tuning.[9] No commenter

---

[8] 64 Fed. Reg. 57,294 (Oct. 22, 1999).

[9] Many commenters enthusiastically supported the Commission's overall approach to revising the Rule. *E.g.,* IL AG, Comment 3, at 10 ("The work done so far to revise the FTC Franchise Rule has been appropriately careful, deliberate and effective."); PMR&W, Comment 4, at 1 ("[W]e would like to compliment the FTC for its forward-thinking and practical approach in a number of areas covered in the NPR."); Holmes, Comment 8, at 1 ("We would like to congratulate the Commission and its staff on the proposal."); H&H, Comment 9, at 2 ("Hogan & Hartson applauds the FTC's efforts at improving franchise regulation by updating disclosure requirements to reflect common industry practices and embracing modern communications

specifically requested a hearing, as permitted in the NPR.[10] A few comments, however, suggested that public workshop conferences might be warranted,[11] or expressed interest in participating in them, if the Commission staff decided to hold one or more.[12] We believe that the current record is sufficient to address the proposed Rule revisions, and we do not contemplate any more hearings or public workshop conferences.

II. ORGANIZATION OF THE REPORT

The Report analyzes the rulemaking record to date, including the comments on the NPR, and sets forth our recommendations regarding the final revised Rule. We first discuss the continuing need for the Rule. Included in that discussion is whether the Commission should revise the Rule's disclosure requirements by incorporating the UFOC Guidelines, as well as modify the Rule's scope by focusing exclusively on franchises, leaving business opportunities to a separate trade regulation rule.

We then turn to the substantive Rule provisions, beginning with our analysis of the proposed definitions. Next, we address franchisors' obligation to furnish disclosure documents, including a discussion of the Rule's international application, as well as the Rule's disclosure trigger provisions. This is followed by a discussion of the disclosure document cover page, table of contents, and the substantive disclosure requirements. We then turn to instructions for

---

technology."); Baer, Comment 11, at 1 ("The Commission has done a remarkably good job overall of addressing many of the deficiencies in the current UFOC Guidelines and proposing in many cases appropriate revisions."); NFC, Comment 12, at 2 ("The FTC's NPR creates a superb platform for calibrating the FTC Franchise Rule to the realities of a robust franchise marketplace which is much different from that of 1979, when the Franchise Rule was promulgated."); Lewis, Comment 15, at 1 ("We support your effort to update and revise the rule."); IFA, Comment 22, at 3 ("The FTC staff has . . . proposed a number of excellent revisions to the Rule."); AFC, Comment 30, at 3 ("AFC would like to commend the FTC and its staff for its franchisors and franchisees today."); J&G, Comment 32, at 1 ("We commend the Commission and its Staff for the work that has gone into the revision and for the many very positive changes that the Proposed Rule reflects."); Tricon, Comment 34, at 1 ("We believe that the Commission has done an excellent job of revising the Franchise Rule."); Marriott, Comment 35, at 2 ("Marriott strongly supports the efforts of the Commission in revising the Rule and the overall direction of the Proposal.").

[10] *See* 64 Fed. Reg. at 57,324; 15 U.S.C. § 57a(c).

[11] *E.g.,* Bundy, Comment 18, at 16; Marriott, Comment 35, at 4.

[12] *E.g.,* PMR&W, Comment 4, at 17; H&H, Comment 9, at 25; Baer, Comment 11, at 17; IFA, Comment 22, at 12-13.

preparing and updating disclosures. Finally, we discuss exemptions, prohibitions, and the Rule's effect on other Commission laws, rules, and orders.

The discussion follows the order of the staff's recommended revised Rule. In each section, we explain how the proposed Rule provision is similar to or different from the current Rule and/or UFOC Guidelines provision. If a proposed section generated any relevant comments, we summarize the comments, and offer our final recommendations. At the conclusion of the Report, we have attached a proposed revised Rule that incorporates our various recommendations (Attachment B). To assist the reader in reviewing our analysis and recommendations, we have also attached a copy of the NPR's proposed Rule (Attachment C) and a table comparing citations to the NPR and the proposed revised Rule (Attachment D).[13]

III. CONTINUING NEED FOR THE FRANCHISE RULE

The staff recommends that the Commission retain a pre-sale disclosure law for franchising. However, we believe the Franchise Rule should be revised to focus exclusively on franchise sales, leaving consideration of business opportunity sales issues to a separate trade regulation rule. Further, we recommend that the Commission revise the Rule's disclosures based upon the UFOC Guidelines model in order to reduce inconsistencies with state pre-sale disclosure laws.

A. The Commission Should Retain the Franchise Rule

During the Rule amendment process, the Commission asked whether the Franchise Rule continues to serve a useful purpose.[14] The commenters who addressed this issue overwhelmingly urged the Commission to retain the Rule.[15] These commenters included many interests, such as the North American Security Administrators Association ("NASAA"), the International Franchise Association ("IFA"), the American Bar Association's Antitrust Section, and major

---

[13] The comparison chart also notes whether NPR proposals have been retained, revised, and/or renumbered. The chart does not note minor, non-substantive edits.

[14] 62 Fed. Reg. at 9,120.

[15] *E.g.,* H&H, ANPR 28, at 2; Kaufmann, ANPR 33, at 2; NCL, ANPR 35, at 2; SBA Advocacy, ANPR 36, at 2-3; IL AG, ANPR 77, at 1. Other ANPR commenters did not specifically address this issue, but we can infer from their general comments that they continued to support pre-sale disclosure. *See, e.g.,* Murphy, ANPR 2, at 1; Brown, ANPR 4 & 6; Cory, ANPR 12. A few ANPR commenters, however, urged the Commission to streamline the Rule and to create greater uniformity with state franchise regulations. *E.g.,* Bruce, ANPR 3; Kaufmann, ANPR 33, at 3; Kestenbaum, ANPR 40, at 1; IL AG, ANPR 77, at 5; Cendant, ANPR 140, at 2. As explained below, franchisees generally did not focus on pre-sale disclosure, but on what they believe to be more pressing substantive relationship issues.

franchisors such as Cendant, a publicly traded company that owns several franchise systems including Howard Johnson, Ramada, Century 21, Coldwell Banker, ERA, and Avis Rent-A-Car.[16]

The commenters maintained that pre-sale disclosure is a cost-effective way to provide material information to prospective franchisees so they can assess the costs, benefits, and potential financial risks involved in entering into a franchise relationship. In particular, pre-sale disclosure enables prospective franchisees to investigate the franchise offering by providing information that is not readily available, such as the franchisor's litigation history and franchisee failure rates.[17]

Other commenters emphasized that pre-sale disclosure is necessary to prevent fraud. For example, franchisor attorney David Kaufmann stated that the Rule has reduced fraud, thereby making it easier for legitimate franchisors to flourish: "Both the Rule and . . . state franchise laws have gone a long way toward eradicating massive franchise frauds and, by doing so, has restored franchising's reputation for integrity and thus cleared the marketplace for the offerings of legitimate franchisors." Kaufmann, ANPR 33, at 3. Other commenters noted that pre-sale disclosure helps franchisees more fully understand the franchise relationship they are entering, as well as the financial and legal commitments they are undertaking,[18] thereby reducing conflicts in franchise systems and potential litigation costs. Indeed, some commenters emphasized that repeal of the Franchise Rule might actually increase franchisors' costs and compliance burdens by opening the door for individual states to enact franchise disclosure laws that may be inconsistent, making it difficult for franchisors to conduct business on a national basis.[19] On the other hand, uniform disclosures would enable prospective franchisees to comparison shop for the best franchise offering,[20] while reducing costs to franchisors. In fact, several franchisors and

---

[16] Other franchisors supporting the Rule include: Better Homes & Gardens Real Estate Service, Re/Max Corporation, and The Prudential Real Estate Affiliates, Inc., RR 24; Snap-On, Inc., RR 27; Little Ceasars, RR 31; The Southland Corporation (7-Eleven), RR 47; Medicap Pharmacies, RR 48; Forte Hotels, RR 52; Pepsico Restaurants (Pizza Hut, Taco Bell, KFC, Inc.), RR 62; Atlantic Richfield Company (ARCO), RR 64; and Papa John's Pizza, RR 74.

[17] *E.g.,* Marks, ANPR, 19Sept97 Tr, at 8-9, 29; Wieczorek, RR, Sept95 Tr, at 62-63.

[18] *E.g.,* H&H, ANPR 28, at 2; SBA Advocacy, ANPR 36, at 2; Zarco & Pardo, ANPR 134, at 1; ABA Antitrust, RR 22, at 7.

[19] *E.g.,* WA Securities, ANPR 117; Shay, RR, Sept95 Tr, at 104.

[20] *E.g.,* Kaufmann, ANPR 33, at 3.

their representatives urged the Commission not only to retain the Franchise Rule, but to preempt the field of franchise pre-sale disclosure law.[21]

While franchisors who commented in the rulemaking uniformly supported the Rule, most franchisees and their advocates criticized the Rule for not going far enough. They want the Rule to address what they believe to be the greatest problem in franchising today: post-sale "abusive franchise relationships."[22] Specifically, they urged the Commission to use its Section 5 unfairness authority to prohibit post-contract covenants not to compete,[23] encroachment of franchisees' market territory,[24] and restrictions on the sources of products or services,[25] among other practices. They also urged the Commission to prohibit franchisors from impeding franchisees from pursuing their legal rights when disputes arise. For example, they would ban franchisors from including in franchise agreements mandatory arbitration and jury trial waiver provisions, as well as choice of venue and choice of law provisions that either impede a franchisee from bringing suit or arguably favor the franchisor in litigation.[26] Indeed, some franchisees asserted that if the Rule cannot address post-sale relationship issues, then the Commission should abolish the Rule.[27]

---

[21] *E.g.,* PMR&W, Comment 4, at 7-8; Baer, Comment 11, at 2; Snap-On, Comment 16, at 1; Cendant, ANPR 140, at 3. *See also* ABA Antitrust, RR 22, at 5. We address preemption below at section XI.B.2.

[22] *E.g.,* Brown, ANPR 4, at 2; Manuszak, ANPR 13; S. Sibent, ANPR 41; Purvin, ANPR 81, at 4; Zarco & Pardo, ANPR 134.

[23] *E.g.,* Brown, ANPR 4, at 3; AFA, ANPR 62, at 3; Slimak, ANPR 130; Leap, ANPR 147, at 1-2; Vidulich, ANPR, 22Aug97 Tr, at 21.

[24] *E.g.,* Brown, ANPR 4, at 2; Donafin, ANPR 14; AFA, ANPR 62, at 1; Buckley, ANPR 97; Zarco & Pardo, ANPR 134, at 2.

[25] *E.g.,* Brown, ANPR 4, at 2; Weaver, ANPR 17; Colenda, ANPR 71; Haines, ANPR 100, at 3; Chiodo, ANPR, 21Nov97 Tr, at 293-94.

[26] *E.g.,* Brown, ANPR 4, at 3; Bell, ANPR 30; D. Iuliano, ANPR 56; AFA, ANPR 62, at 3; Johnson, ANPR 67.

[27] *See* AFA, ANPR 62, at 1 ("Our members feel so strongly about the Commission's inability to deal with substantive issues of concern to them, they would rather work to abolish the FTC rule than suffer the abuses of both a government agency *and* their franchisors.").

Based upon the record and the Commission's law enforcement experience over the last twenty years,[28] the staff is persuaded that pre-sale disclosure is warranted to protect prospective franchisees from fraudulent and deceptive franchise sales practices. Pre-sale disclosure also enables a prospective franchisee to conduct his or her own due diligence investigation of the franchise offering, thereby giving the prospect a better understanding of the significant financial risks and legal obligations involved in purchasing a franchise. Indeed, franchisee concerns about various relationship issues further persuades us that pre-sale disclosure remains necessary to ensure that prospective franchisees are fully informed about the relationships that they will be entering, including issues such as source restrictions and any rights to protected territories.

At the same time, the staff recognizes that pre-sale disclosure addresses only some of the issues franchisees may face in owning and operating their franchises. From the comments and statements submitted by franchisees, there is little doubt that some franchisees are dissatisfied with their franchise purchase. Others asserted that, despite the Rule, a serious power imbalance continues to exist between franchisors and franchisees and that franchise contracts are oppressive. They urged the Commission to address post-sale franchise relationship issues directly through its Section 5 unfairness jurisdiction.[29]

---

[28] As of the date of this Report, the Commission has filed more than 200 suits against more than 650 defendants (both franchises and business opportunities) for Franchise Rule violations since the Rule was promulgated in the late 1970s.

[29] It is not uncommon for franchisees to lose several hundred thousand dollars or more in bad franchise investments. *E.g.,* Slimak, ANPR, 22Aug97 Tr, at 26 and ANPR 130 ($289,000 loss); Lundquist, ANPR, 22Aug97 Tr, at 48 (half a million dollar loss). Susan Kezios, the President of the American Franchisee Association, noted that a study conducted by Dr. Timothy Bates found that 38% of new franchises failed within a ten year period (1986-87 through 1996), as opposed to 32% of independent businesses. Further, based upon "industry statistics," 180 new franchises open each day, at a cost of approximately $18 million ($100,000 per franchise). Applying Mr. Bates' figures, she estimated that each day franchisees lose approximately $7 million (38% of $18 million). Kezios, ANPR, 22Aug97 Tr, at 64-66. *See also* Staff of the Bureau of Consumer Protection, *Franchise and Business Opportunity Program Review 1993-2000: A Review of Complaint Data, Law Enforcement and Consumer Education* (June 2001) ("Staff Program Review"), at 16 (Chart C.4.) (87 franchise complaints alleged injury over $10,000, 11 of those alleged injury over $100,000); House Committee on Small Business, *Franchising in the U.S. Economy: Prospects and Problems*, 101st Cong. 2nd Sess. (1990), at 23 (citing joint report from NASAA and Council of Better Business Bureaus estimating that "tens of thousands of individuals continue to lose as much as $500 million annually in franchise and business opportunity fraud."). *See generally* Timothy Bates, *Survival Patterns Among Newcomers to Franchising* (Nov. 1996) (reprinted at ANPR 143).

For the reasons stated in the NPR, however, the Commission lacks the statutory ability to broaden the Rule to address post-sale franchise relationship issues.[30] As an initial matter, franchise relationships are private, contractual matters that are regulated at the state level. Indeed, absent specific statutory authority, the Commission traditionally has not sought to regulate or set the terms of private contracts in any economic sector.[31] More important, a widespread misconception exists about the scope of the Commission's Section 5 "unfairness" jurisdiction. In 1994, Congress amended Section 5 of the FTC Act, adopting the following definition of unfairness:

> The Commission shall have no authority . . . to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.

---

[30] 64 Fed. Reg. at 57,296.

[31] The Commission's "unfairness" jurisdiction generally does not authorize the Commission to dictate the terms and conditions of private franchise agreements. For example, the Commission's Funeral Rule, 16 C.F.R. Part 453, requires funeral homes to disclose pre-sale the cost of its goods and services, but does not regulate the terms and conditions of private funeral services contracts. Similarly, the Used Car Rule, 16 C.F.R. Part 455, requires used car sellers to disclose pre-sale whether the car comes with a warranty, but does not regulate the terms and conditions of private used car sales. To the contrary, "unfairness" enables the Commission to hold a company to the contractual terms it freely selects when it seeks to modify its contract unilaterally. In the seminal "unfairness" case involving contract performance, *Orkin Exterminating Co. v. FTC,* 849 F.2d 1354 (11th Cir. 1988), *cert. denied,* 488 U.S. 1041 (1989), the Eleventh Circuit upheld the Commission's finding that Orkin engaged in unfair conduct in violation of Section 5 by unilaterally modifying its contracts with over 200,000 consumers. 849 F.2d at 1364-66. In that case, the Commission did not exercise its unfairness jurisdiction to revise Orkin's contracts or to dictate substantive contractual terms. Rather, the Commission required Orkin to honor the contractual terms that Orkin freely chose and offered to the public. *Cf. Shute v. Carnival Cruise Lines,* 897 F.2d 377 (9th Cir. 1990), *rev'd* 499 U.S. 585 (1991) (upholding choice of forum clause against "fundamental fairness" challenges on the grounds that the parties had notice of the provisions, the absence of fraud, and the existence of countervailing benefits).

15 U.S.C. § 45(n).[32] The evidence in the ongoing rulemaking proceeding fails to establish that post-sale franchise relationships are legally "unfair," as defined above.

There is no question that the record reveals that some franchisees have suffered harm in the course of operating their franchises. However, we have no basis to quantify the level of harm. Specifically, we cannot determine how much of the injury is attributable to actions taken by the franchisor, by franchisees, or to other factors, such as downturns in the economy or shifting consumer preferences. In the absence of such data, we cannot conclude that the level of harm suffered by individual franchisees as a result of the franchise relationship rises throughout franchising to the statutory "substantial injury" level.[33] Further, we have no basis to conclude that any such injuries to individual franchisees outweigh countervailing benefits to the public at large or to competition.

Most important, in many instances injury to franchisees can reasonably be avoided. A franchise purchase is entirely voluntary. Prospective franchisees can avoid harm by comparison shopping for a franchise system that offers more favorable terms and conditions, or by considering alternatives to franchising as a means of operating a business. Further, the Franchise Rule ensures that each prospective franchisee receives disclosures that explain the terms and conditions under which the franchise will operate. Prospective franchisees are also free to discuss the nature of the franchise system with existing and former franchisees. Under these circumstances, the Commission can hardly conclude that prospective franchisees who voluntarily enter into franchise agreements after receiving full disclosure, nonetheless cannot reasonably avoid harm resulting from a franchisor enforcing the terms of the franchise agreement.[34] As a result, the Commission has no authority to engage in a far-reaching rulemaking that would mandate the substantive terms of all private franchise contracts.

Our conclusion that substantive franchise rulemaking is unwarranted is also supported by a staff review of post-sale franchise relationship issues, as reflected in the Commission's complaint database – the Consumer Information System ("CIS"). During the period 1993

---

[32] *See also FTC v. J.K. Publ'ns, Inc.,* 99 F. Supp.2d 1176, 1201 (C.D. Cal. 2000).

[33] In its recent audit of the Commission's Franchise Rule Program, the General Accounting Office ("GOA") concluded that there are "no readily available, statistically reliable data on the overall extent and nature of [franchise relationship] problems." U.S. General Accounting Office, *GAO Report to Congressional Requesters, Federal Trade Commission Enforcement of the Franchise Rule*, GAO-01-776 (July 31, 2001) at 29.

[34] *See J.K. Publ'ns*, 99 F. Supp.2d at 1201 ("With regard to [avoidability], the focus is on 'whether consumers had a free and informed choice that would have enabled them to avoid the unfair practice.'").

through June 1999, franchisees raised post-sale relationship issues involving 110 companies.[35] This means that about 95% of the approximately 2,500[36] franchise systems operating in North America at that time did not generate even a single relationship complaint to the Commission. Moreover, the vast majority of companies that were the subject of a complaint generated only one complaint,[37] as illustrated below:

Franchise Complaints

Number of Complaints	Franchisors Generating The Specified Number of Complaints
One complaint	91 companies
Two complaints	12 companies
Three complaints	6 companies
Four complaints	2 companies
Five complaints	1 company
Six complaints	0 companies
Seven complaints	0 companies
Eight complaints	1 company

_____Nonetheless, we believe the record is sufficient to show that information about the state of the franchise relationship is material and more disclosure is warranted to ensure that prospective franchisees understand the quality of the franchise relationship before they commit to buying a franchise. To that end, we recommend that the Commission expand the Rule's pre-sale disclosures in a few instances to address relationship issues. This approach is consistent with the Commission's long-held view that free and informed consumer choice is the best regulator of the market.

---

[35] This number excludes seventeen complaints that did not identify a specific franchisor.

[36] *See* Bond's Franchise Guide (11th ed. 1998) at 9, 25 (estimating there are 2,500 American and Canadian franchisors). Currently, Bond's maintains a database of 2,500 North American franchisors, and its Franchise Guide (13th ed. 2001) provides information on approximately 2,150 of those systems, that in its view, are actively engaged in franchising.

[37] *See* Staff Program Review at 42.

B. The Rule Should Be Narrowed To Focus On Franchises Exclusively

While we recommend that the Commission retain the Rule, we believe the scope of the Rule should be limited to focus exclusively on franchise sales. Throughout the Rule amendment process, the Commission has proposed separating the disclosure requirements for franchises from those for business opportunities.[38] Indeed, the NPR did not address the issue of business opportunities at all. Rather, the Commission proposed addressing business opportunity sales in a separate rulemaking.[39]

Commenters who addressed this issue agreed that there should be a separate rule for business opportunity sales, stressing that franchises and business opportunities are distinct business arrangements.[40] David Muncie, a business opportunity seller, succinctly described the disadvantages of addressing business opportunities and franchises under the same rule as follows:

> It would be extremely unwise to attempt to lump business opportunities into the same category as franchises. They are entirely different business arrangements. Business opportunities do not demand or extract a percentage of income from the purchaser to use for national advertising or mere profit overrides, nor does the purchaser of a business opportunity use the same name or trade name as does a franchisee. There is also a far greater amount of training which is provided to franchisees by franchisors. Furthermore, franchisers exert a far greater degree of

---

[38] 62 Fed. Reg. at 9,120 (ANPR); 60 Fed. Reg. at 17,657-58 (Rule Review).

[39] 64 Fed. Reg. at 57,296.

[40] *E.g.,* PMR&W, Comment 4, at 2; 7-Eleven, Comment 10, at 2; IFA, Comment 22, at 4; Stadfeld, Comment 23, at 3-4; Caffey, ANPR 94; Jeffers, ANPR 116, at 2; NASAA, ANPR 120, at 4-5. Several commenters suggested that the Commission should create a separate business opportunity rule along the lines of state business opportunity disclosure acts. *E.g.,* Muncie, ANPR 15, at 1 (suggesting the Commission follow the California Seller Assisted Marketing Plan Act); WA Securities, ANPR 117, at 2 (suggesting the Commission follow the NASAA Model Business Opportunity Act). NCL, however, took the contrary view:

> While there may be clear distinctions with those involved in the trade for franchises and business opportunities, the consumers who contact the NFIC are unaware of the differences. Moreover, a review of the NFIC complaints received in 1996 reveals that more involve business opportunities than franchises. This indicates that the same pre-sale disclosures are needed for business opportunities as for franchises.

NCL, ANPR 35, at 3.

> control over the operation of the business than do business opportunity vendors. Business opportunities are also sold at a much cheaper price. *Lumping them together in one category would spell the death knell for legitimate business opportunity vendors*. They would not be able to comply with the requirements and still market their product to those who are not capable of raising extremely large sums of money, often in the hundreds of thousands of dollars, as required to purchase most legitimate franchises. *It would not, however, have any effect on the . . . sleazeball vendors who neglect to and refuse to follow existing federal and state legislation and who will continue to do the same with any changes you institute. Therefore I see no value in lumping the two entirely different business arrangements into one category. It would only serve to drive legitimate companies out of the marketplace, thereby harming consumers*.

Muncie, ANPR 15, at 2 (emphasis in original).[41]

We agree that business opportunities and franchises are distinct business arrangements that warrant different disclosure approaches.[42] For example, many of the Rule's pre-sale disclosures, in particular those pertaining to the parties' detailed contractual relationship, do not apply to most business opportunity sales, 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 by imposing compliance costs that are not likely to be recovered by the sale. Moreover, our principal concern about business opportunities sales is outright fraud. A string of business opportunity related law enforcement sweeps – beginning with Project Telesweep in 1995[43] – illustrates that fraud artists often take advantage of relatively

---

[41] *See also* PMR&W, Comment 4, at 2 ("Purchasers of franchises, compared to purchasers of business opportunities, typically are better educated, better financed, have greater business experience, make a larger investment, and are more likely to evaluate their proposed investment with the assistance of other knowledgeable professionals such as attorneys, accountants, and officers of lending institutions.").

[42] A few commenters urged the Commission to continue to enforce the current Franchise Rule for business opportunities until such time as the new Business Opportunity Rule is promulgated. *E.g.,* IL AG, Comment 3, at 9. We agree. Accordingly, we recommend that the Commission publish, along with the revised Franchise Rule, an amended and renumbered version of the current Rule limited to business opportunities only.

[43] Other examples of business opportunity related sweeps include: Project Buylines (1996); Project Missed Fortune (1996), Project Trade Name Games (1997), Project Vend-Up Broke (1998); Project "Biz-illions" (2000); and Project Busted Opportunities (2002).

unsophisticated business opportunity buyers.[44] To combat such fraud, the staff recommends that the Commission promulgate a separate business opportunity rule containing a few, narrowly-tailored disclosures to give prospective buyers material information about the offer, as well as appropriate prohibitions targeting specific fraudulent practices.

C. The Commission Should Revise the Franchise Rule's Disclosures Based On The UFOC Guidelines Model

The primary goal of the Rule revision is to ensure that the Franchise Rule continues to provide material information to prospective franchisees so they can make an informed investment decision, while reducing unnecessary costs and burdens on franchisors. One of the chief avenues to reducing compliance costs and burdens is to adopt, where warranted, the UFOC Guidelines disclosure format. Indeed, many franchisors are familiar with the Guidelines and have prepared UFOCs for a number of years. Our recommendations, therefore, strive to reduce unnecessary inconsistencies between federal and state franchise disclosure law.[45]

Without exception, commenters who addressed the issue – franchisors and franchisees alike – urged the Commission to revise the Rule to mirror the UFOC Guidelines' disclosures.[46]

---

[44] During our review of the Franchise and Business Opportunity Program, we found that 75% of the 4,512 complaints in the staff's franchise and business opportunity database (3,392 complaints) pertained to business opportunities, while only slightly more than 6% concerned franchisors.

[45] We are assisted in this effort by a NASAA document entitled "Comparison of UFOC and Proposed FTC Disclosure Requirements" ("NASAA Comparison") (Jan. 8, 2002). A copy of this document has been placed on the rulemaking record and is also available at NASAA's website: www.NASAA.org. Several commenters also urged the Commission to adopt the UFOC Guidelines' instructions and sample answers, as well as periodic commentaries. *E.g.,* IL AG, Comment 3, at 1; PMR&W, Comment 4, at 7; NASAA, Comment 17, at 4; J&G, Comment 32, at 2. To the extent that the UFOC Guidelines' text, instructions, sample answers, and commentaries are substantive, we agree and have considered them for inclusion in the Rule. However, we believe purely explanatory materials in the UFOC Guidelines and NASAA Commentary are better placed in a Compliance Guide that will accompany the revised Rule, where the issues involved can be discussed at length. This is consistent with the Commission's prior practice in issuing Final Interpretive Guides along with the Rule.

[46] *E.g.,* PMR&W, Comment 4, at 1; H&H, Comment 9, at 2; 7-Eleven, Comment 10, at 2; NFC, Comment 12, at 2; Lewis, Comment 15, at 5; NASAA, Comment 17, at 3-4; Bundy, Comment 18, at 6; Gurnick, Comment 21, at 2; IFA, Comment 22, at 4-5; Stadfeld, Comment 23, at 2; J&G, Comment 32, at 2; Marriott, Comment 35, at 2; Brown, ANPR 4, at 1; Duvall, ANPR 19, at 1; Baer, ANPR 25, at 2; Kaufmann, ANPR 33, at 3; SBA Advocacy, ANPR 36, at 3; Kestenbaum, ANPR 40, at 1; AFA, ANPR 62, at 2; IL AG, ANPR 77, at 1, WA Securities,

These commenters emphasized that the UFOC Guidelines have more expanded disclosures than the current Rule,[47] are already used by the vast majority of franchisors,[48] and, in fact, are the national industry standard.[49] Uniformity between federal and state franchise laws will also help to reduce compliance costs[50] and facilitate comparison shopping among franchise systems.[51] Moreover, as NASAA noted, the UFOC Guidelines were developed with significant input from franchisors, franchisees, and franchise administrators, and were subject to public hearings and notice and comment.[52] Therefore, the UFOC Guidelines reflect a balance of interests among all effected parties.

To that end, the proposed revised Rule adopts many of the UFOC Guidelines without change or with minor edits. Indeed, the proposed revised Rule will look familiar to franchise practitioners. To reduce inconsistencies, we have rejected isolated suggestions to reduce, expand, or restructure the UFOC Guidelines.[53] No doubt, eliminating certain disclosures might reduce franchisors' compliance costs and burdens, while expanding disclosures might afford some additional franchisee protections. In most instances, however, such steps would not outweigh the benefits of reducing inconsistencies between federal and state law.

At the same time, the proposed revised Rule is not identical to the UFOC Guidelines. The revised Rule diverges from the UFOC Guidelines in two respects. First, in a few instances,

---

ANPR 117, at 1; Selden, ANPR 133, at 1; Zaco & Pardo, ANPR 134, at 1; Cendant, ANPR 140, at 2.

[47] *E.g.,* 7-Eleven, Comment 10, at 2; NASAA, 17, at 3-4; Kaufmann, ANPR 33, at 3; AFA, ANPR 62, at 2; IL AG, ANPR 77, at 1; WA Securities, ANPR 117, at 1.

[48] *E.g.,* H&H, ANPR 28, at 5-6; Kaufmann, ANPR 33, at 3; Kestenbaum, ANPR 40, at 1; WA Securities, ANPR 117, at 1.

[49] *E.g.,* IFA, Comment 22, at 4-5; Stadfeld, Comment 23, at 2; Karp, ANPR, 19Sept97 Tr, at 90.

[50] *E.g.,* AFA, ANPR 62, at 2; WA Securities, ANPR 117, at 1; NASAA, ANPR 120, at 3.

[51] IL AG, Comment 3, at 1; Kaufmann, ANPR 33, at 3; ABA Antitrust, RR 22, at 7.

[52] NASAA, ANPR 120, at 2. *See also* WA Securities, ANPR 117, at 1.

[53] Frandata, for example, proposed that the Commission restructure several of the Rule's disclosures to create standardized "fill-in the blank" provisions. For instance, rather than a narrative describing the franchisor's background, Frandata suggested that the franchisor complete specific sentences such as: "(i) The year we began conducting a business of the type to be operated by franchisees was _____. (ii) The year we began to offer the sale of franchises of the type to be operated by franchisees was _____." Frandata, Comment 29, at 7.

we have eliminated or streamlined a UFOC Guideline disclosure that is unnecessary or is overly burdensome. In the same vein, we also deviate from the UFOC Guidelines where the record shows that a UFOC Guidelines' disclosure is broken and needs to be fixed.

Second, the proposed revised Rule deviates from the UFOC Guidelines by adding a few narrowly tailored disclosures based upon the Commission's law enforcement experience and to shed additional light on the quality of the franchise relationship. For example, we propose that the Commission expand the Item 3 litigation disclosures to include franchisor-initiated litigation, as well as expand the Item 20 franchisee statistics to include information about confidentiality clauses and trademark-specific franchisee associations.

Further, we note that the UFOC Guidelines focus primarily on disclosures. They do not address issues such as the timing of making disclosures, liability for Rule violations, exemptions, or prohibitions. Such provisions are typically addressed in state statutes or regulations, which often vary. Accordingly, our goal of reducing inconsistencies between federal and state law is limited primarily to disclosures, with the exception of some definitions and instructions for preparing disclosures that exist in the UFOC Guidelines. Nonetheless, our proposals incorporate several state franchise law principles, such as permitting a 120-day annual update requirement.[54] In all other respects, our recommendations are based upon the record and our law enforcement experience.

IV. PROPOSED SECTION 436.1: DEFINITIONS

Currently, the Franchise Rule places the definitions after the substantive disclosure requirements, in no apparent order. In the NPR, the Commission proposed making the Rule more user-friendly by placing the definitions in alphabetical order at the beginning of the Rule. For the most part, the proposed definitions are similar to those already contained in either the Rule or UFOC Guidelines. The NPR, however, proposed eliminating four current definitions that we believe no longer serve a useful purpose: (1) "business day";[55] (2) "time for making of disclosures";[56] (3) "personal meeting";[57] and (4) "cooperative association."[58] At the same time it

---

[54] *See* section VIII.B.1. below.

[55] 16 C.F.R. § 436.2(f).

[56] *Id.* at § 436.2(g).

[57] *Id. at* § 436.2(o). Franchisors currently must provide disclosure documents at the earlier of the first "personal meeting" or "the time for making disclosures," which generally means 10 business days before the prospective franchisee pays any fee or signs any contract in connection with the franchise sale. As part of our effort to streamline the Rule, we recommend eliminating these timing provisions in favor of a clear, bright-line 14-day provision. *See* 64 Fed. Reg. at 57,300-01. If this recommendation were adopted, the terms "time for making disclosures"

would add several new definitions for the terms "action," "confidentiality clause," "financial performance representation," "Plain English," "predecessor," "principal business address," "signature," "trademark," and "written." Six of the definitions proposed in the NPR generated no comment: "disclose,"[59] "fiscal year,"[60] "plain English,"[61] "principal business address,"[62]

"personal meeting" and "business day" would become obsolete.

[58] 16 C.F.R. at § 436.2(l). Cooperative associations are one of four non-franchise relationships that the Commission has excluded from the Rule. Unlike Rule exemptions (which are substantive limitations on the Rule's reach), the exclusions are explanatory, helping the public better distinguish between franchise and non-franchise relationships. The NPR proposed streamlining the Rule by eliminating these exclusions on the grounds that they no longer serve a useful purpose. *See* 64 Fed. Reg. at 57,319. As explained below at section IX.B.5 of this Report, some commenters continue to believe that the four exclusions are necessary to help understand the Rule's scope. To the extent that the four exclusions are explanatory, we propose that they be placed in the Compliance Guides that will accompany the revised Rule.

[59] 64 Fed Reg. at 57,332. "'Disclose' means to state all material facts accurately, clearly, concisely, and legibly in plain English." *See* UFOC Guidelines, General Instruction 150. Because the proposed Rule also uses similar terms – state, describe, and list – we recommend that the Commission add those terms to the definition of "disclose" as well. Accordingly, the proposed definition of "disclose" now would read "disclose, state, describe, and list mean to present all material facts accurately, clearly, and concisely, and legibly in plain English." We also recommend that the Commission make clear in the Compliance Guides that clear, conspicuous, and legible requires that disclosures be made in at least 12 point upper and lower case type. This is consistent with the current Commission approach. *See, e.g.*, 16 C.F.R. § 436.1(b)(4) ("clearly and conspicuously disclosed . . . in not less than twelve point upper and lower case . . . type.").

[60] 64 Fed. Reg. at 57, 332. "Fiscal year" refers to the franchisor's fiscal year. *See* 16 C.F.R. § 436.2(m).

[61] 64 Fed. Reg. at 57,332. The definition of "plain English" would be new, accompanying a new requirement that disclosure documents be prepared in "plain English." "'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." *See* Registration Form Used by Open-Ended Management Investment Companies, SEC Release No. 33-7512, 17 C.F.R. 274.11A. *See also* UFOC Guidelines, General Instruction 150.

[62] 64 Fed. Reg. at 57,332. "'Principal business address' means the street 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." *See* UFOC Guidelines, Item 1C Instructions, i.

"trademark,"[63] and "written."[64] We recommend, therefore, that the Commission adopt these six definitions in the final revised Rule. Based upon the comments received, we further recommend fine-tuning several proposed definitions, as explained below. Specifically, we recommend that the Commission eliminate three definitions that appeared in the NPR: "Internet,"[65] "material,"[66] and "officer."[67] Finally, we recommend that the Commission add a definition for the term "parent."

A. Proposed Section 436.1(a): Action

1. Background

Consistent with the current Rule, proposed Item 3 of the NPR would require the disclosure of certain legal actions involving the franchisor and certain directors and officers.[68] The Rule, however, currently does not define the term "action."

In the NPR, the Commission proposed adopting the UFOC Guidelines' definition of the term "action": "*Action* includes complaints, cross claims, counterclaims, and third-party complaints in a judicial proceeding, and their equivalents in an administrative action or arbitration proceeding." 64 Fed. Reg. at 57,331.[69] This proposed definition is consistent with the

---

[63] 64 Fed. Reg. at 57,333. "'Trademark' includes trademarks, service marks, names, logos, and other commercial symbols." *See* Final Interpretive Guides, 44 Fed. Reg. at 49,966. *See also* UFOC Guidelines, Item 13 Instructions, i.

[64] 64 Fed. Reg. at 57,333. The proposed definition of "written" would update the Rule to include electronic disclosures: "'Written' or 'in writing' means any document or 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; information on computer disk or CD Rom; information sent via email; or information posted on the Internet. It does not include mere oral statements."

[65] *Id*. at 57,332.

[66] *Id.*

[67] *Id.*

[68] *Id.* at 57,334. *See also* 16 C.F.R. § 436.1(a)(4).

[69] *See also* UFOC Guidelines, Item 3 Definitions, ii.

Commission's interpretation of the term "action," as discussed in the Final Interpretive Guides to the Franchise Rule.[70]

2. The record and recommendations

The NPR's proposed definition of "action" generated two comments. First, the NFC urged the Commission to modify the definition to read "judicial action or proceeding," rather than just "judicial proceeding." It observed that in some states a "judicial action" is an action at law, while a "proceeding" is equitable.[71] Second, Warren Lewis recommended that the definition's reference to complaints be limited to "served complaints." He asserted that a franchisor should not have to disclose actions filed against it unless the franchisor has actually been served with a complaint.[72]

The staff recommends that the Commission modify the NPR proposal by adopting the NFC's suggestion that the term "action" reference both judicial actions and proceedings. This approach is consistent with the practice in some states. Accordingly, the revised definition of "action" would read: "*Action* includes complaints, cross claims, counterclaims, and third-party complaints in a judicial action or proceeding, and their equivalents in an administrative action or arbitration."

However, we do not agree with Mr. Lewis that the definition of "action" should be limited to only "served complaints."[73] Such a narrowing of the definition would effectively enable a franchisor to avoid disclosing potentially material litigation, even though it had notice of

---

[70] 44 Fed. Reg. 49,966, 49,973 (Aug. 24, 1979).

[71] NFC, Comment 12, at 25. *See generally, e.g., Detroit Auto. Inter-Insurance Exch. v. Gavin,* 416 Mich 407, 331 N.W. 2d 418 (1981); *Spitcaufsky v. Hatten,* 353 Mo. 94, 182 S.W. 2d 86 (1944); *Dzubin v. Dzubin,* 121 Conn. 646, 186 A. 652 (1936).

[72] Lewis, Comment 15, at 7.

[73] The issue of lack of knowledge of filed complaints does not appear to be a significant concern. In more than 20 years enforcing the Rule, we are unaware of any instance in which a franchisor was charged with violating the Rule by failing to disclose litigation where it had not yet been served with a complaint. Further, as we propose below, an individual franchise seller will be held liable for a disclosure violation only if he or she knew or should have known that a disclosure was incomplete or inaccurate. This goes a long way to ensuring that franchisors and individual franchise sellers will not be held liable for failures to disclose where they are unaware of the underlying facts. Also, unlike the states, the Commission does not have an immediate updating requirement. The Rule's annual and quarterly update provisions discussed below, in most instances give the franchisor reasonable time to learn about any such complaints and to update their disclosures accordingly.

an action, merely because it has not been served with the papers yet or has successfully avoided service of process.[74] In short, a franchisor has no reason to conceal a known, but unserved, complaint.

B. Proposed Section 436.1(b): Affiliate

1. Background

Many of the proposed revised Rule's disclosures would pertain to the franchisor and its affiliates alike.[75] The Franchise Rule currently defines the term "affiliated person" to mean 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). In the NPR, the Commission proposed that the Rule adopt the UFOC Guideline's streamlined definition of the term affiliate:[76] "*Affiliate* means an entity controlled by, controlling, or under common control with, the franchisor."[77]

---

[74] It is not uncommon in the Commission's law enforcement experience for defendants to know that a Commission action was filed prior to service either by learning of the suit from co-defendants or as a result of an asset freeze. *E.g., FTC v. Joseph Hayes,* No. 4:96CV02162SNL (E.D. Mo. 1996).

[75] *E.g.,* Item 1; Items 3-6; Item 8; and Item 10.

[76] *See* NASAA Commentary on the Uniform Franchise Offering Circular Guidelines (1999), Bus. Franchise Guide (CCH), ¶ 5790, at 8,466 ("NASAA Commentary" or "Commentary"). The Commentary notes that this general definition of affiliate should be used throughout a UFOC, unless a particular disclosure Item defines it differently or limits its use. For example, for purposes of Item 1, the definition of affiliate is narrowed to an affiliate "which is offering franchises in any line of busines or is providing products or services to the franchisees of the franchisor." *See* UFOC Guidelines, Item 1 Instructions, v.

[77] 64 Fed. Reg. at 57,332.

2. The record and recommendations

Only one commenter raised any concern about the NPR's proposed "affiliate" definition. Triarc would broaden the proposed definition to reference affiliates of franchisees.[78] This suggestion relates to the NPR's proposed Rule exemption for sophisticated franchisees with five years of prior experience and $5 million in assets.[79] As discussed in the exemptions section below, we recommend that the Commission permit consideration of a franchisee-affiliates' assets and prior experience in satisfying the proposed exemption's prior experience and monetary thresholds.[80] For example, a franchisor selling a franchise to a new subsidiary of a corporate-franchisee should be able to rely on the subsidiary's parent's assets and net worth in qualifying for the sophisticated franchisee exemption. If so, then we agree that the definition of "affiliate" should be expanded to reference entities controlled by a franchisee. The revised definition would read:

> *Affiliate* means an entity controlled by, controlling, or under common control with, the franchisor or a franchisee.[81]

C. Proposed Section 436.1(c): Confidentiality Clause

1. Background

In the NPR, the Commission proposed a new disclosure to address contractual provisions that prohibit or restrict existing or former franchisees from discussing their experience with prospective franchisees.[82] To that end, the NPR proposed using the term "*gag clause*," which it defined as follows:

> 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

---

[78] Triarc, Comment 6, at 2.

[79] *See* 64 Fed. Reg. at 57,321.

[80] Triarc, Comment 6, at 2.

[81] This definition would include a subsidiary of the franchisor, a parent of the franchisor, as well as "sister" subsidiaries of a franchisor.

[82] We discuss the merits of this proposal below at section VI.V.2.b.

include confidentiality agreements that protect franchisor's trademarks or other proprietary information.

64 Fed Reg. at 57,332.[83]

2. The record and recommendations

Several commenters opposed the term "gag clause" because, in their view, it is pejorative. They prefer a neutral term, such as "confidentiality agreement,"[84] "confidentiality clause," "nondisclosure clause,"[85] or "privacy clause."[86] We agree and recommend that the Commission revise the NPR by adopting the term "confidentiality clause."

Other commenters questioned the scope of the proposed definition. PMR&W, for example, would limit the definition to broad speech restrictions ("no-communications" clauses) that would prohibit existing or former franchisees from discussing any matters about the franchise system whatsoever.[87] H&H suggested that the definition be limited to those confidentiality clauses that bar franchisees from discussing matters specifically with prospective franchisees.[88] The NFC would go further, limiting the definition to instances "where either all franchisees, or at least twenty percent of the franchisee population, is barred from communicating with third parties." NFC, Comment 12, at 33. Tricon questioned whether an agreement that restricts disclosure of only the monetary terms in a settlement should trigger the proposed Item 20 disclosure about the use of such clauses.[89]

Several franchisee advocates voiced concern about the last part of the proposed definition, the proprietary information exclusion. Howard Bundy, for example, feared that a franchisor could avoid the Rule simply by requiring a franchisee to sign a contractual provision

---

[83] In the ANPR, the Commission used the term "gag order." During the New York public workshop conference, several panelists were confused by the word "order," noting that it implied a court mandate. Forseth, ANPR, 18Sept97 Tr, at 40; Zaslav, *id*, at 55. To correct this confusion, the term "gag *clause*" was introduced in the NPR to avoid any implication that the Commission is concerned with only court-imposed speech restrictions.

[84] NFC, Comment 12, at 26.

[85] Lewis, Comment 15, at 9.

[86] BI, Comment 28, at 10.

[87] PMR&W, Comment 4, at 15.

[88] H&H, Comment 9, at 15.

[89] Tricon, Comment 34, at 3.

agreeing that the existence of a confidentiality clause itself is proprietary information. He suggested that the "better approach would be to exclude confidentiality agreements that 'only' or 'merely' protect . . . proprietary information and then specifically state that [confidentiality] clauses, themselves, can never be proprietary information." Bundy, Comment 18, at 3.[90]

We agree with H&H that the NPR's proposed definition may be broader than warranted. As explained below, this proposed disclosure is intended to aid prospective franchisees' due diligence investigation. Accordingly, it is unnecessary to address confidentiality clauses directed at persons other than prospective franchisees, such as the media. At the same time, narrowing the definition to clauses that specifically restrict speech with prospective franchisees goes too far. A franchisor could easily avoid the proposed confidentiality clause disclosure by simply using a broader clause (such as a "no communications with anyone" clause). Rather, we believe the definition of confidentiality clause should cover all confidentiality clauses that have the net effect of restricting speech with prospective franchisees. To that end, we recommend the language "*directly or indirectly* restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor's system with any prospective franchisee."

Similarly, we agree with Tricon that a confidentiality clause disclosure should not cover specific settlement terms if the franchisee is free to discuss his or her experience within the franchise system. Because this would aid in explaining the scope of the definition, we believe this issue would be most appropriately addressed in the Compliance Guides.

We reject, however, suggestions that the Commission significantly narrow the definition to cover only broad "no-communications clauses" or only circumstances where all or at least 20% of franchisees are under speech restrictions. Specifically, as in other sections of this Report, we reject thresholds in favor of bright-line provisions that enable franchisors, prospective franchisees, and law enforcers to know when a Rule provision applies, without resort to fact-finding. Further, these proposals are narrower than necessary and would defeat the very purpose of the proposed confidentiality clause disclosure.

Finally, we believe Mr. Bundy's suggestion goes too far. Many ANPR commenters – both franchisor and franchisee representatives – agreed that proprietary information should be exempted from the definition of confidentiality clause because a franchisor has a reasonable and legitimate concern about protecting its trademark and business secrets.[91] We believe attempts to expand the concept of proprietary information to include confidentiality clauses would fail because the Commission would apply an objective standard in determining what is "proprietary," that is, whether a particular confidentiality clause protects information that would normally be regarded as proprietary, such as trade secrets. For this reason, we believe the proposed definition is sufficient to address this concern.

---

[90] *See also* Karp, Comment 24, at 21-22.

[91] *E.g.,* Baer, ANPR 25, at 3; AFA, ANPR 62, at 3; Zarco & Pardo, ANPR 134, at 4.

For these reasons, we recommend that the Commission revise the NPR's proposed definition of "gag clause" as follows:

> *Confidentiality clause* means any contract, order, or settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor's system with any prospective franchisee. It does not include confidentiality clauses that protect a franchisor's trademarks or other proprietary information.

D. Proposed Section 436.1(e): Financial Performance Representation

1. Background

One of the most important sections of the proposed revised Rule is Item 19, which addresses the making of financial performance representations. Currently, the Rule describes performance information as "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." 16 C.F.R. §§ 436.1(b) and (c). This is similar to the UFOC Guidelines' definition of "earnings claim."[92]

In the NPR, the Commission proposed defining the term "financial performance representation" explicitly, borrowing from both the current Rule and UFOC Guidelines' definitions, as follows:

> *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.

64 Fed. Reg. at 57,332.

This proposed definition incorporates the current Rule's approach that an "oral, written and visual" representation will constitute a financial performance representation.[93] To ensure

---

[92] *See* UFOC Guidelines, Item 19 Instructions, i.

[93] *See, e.g.,* 16 C.F.R. § 436.(1)(b).

that the Rule covers implied financial performance representations, the definition also retains the phrase "or which states other figures which suggest such a specific level." *Id.*[94]

The proposed definition also incorporates references in the comparable UFOC Guidelines' definition[95] to "actual" and "potential" performance, capturing both historical financial performance and projections[96] as well as the use of charts, tables, and mathematical calculations.[97] Finally, the proposed definition updates the Rule by clarifying that financial performance representations made in the general media include those representations made through the Internet.

2. The record and recommendations

In response to the NPR, commenters raised essentially three concerns: (1) whether the proposed financial performance definition adequately addresses implied performance representations; (2) whether the definition should exclude cost information; and (3) whether the

---

[94] The proposed definition also uses the more exclusive term "financial performance" representation, rather than the limited term "earnings claim." Some industries, such as hotels, use variables other than earnings to measure performance, such as room occupancy rates. *See* 64 Fed. Reg. at 57,297.

[95] The UFOC Guidelines use the term "earnings claims," which is defined as:

> information given to a prospective franchisee by, on behalf of or at the direction of the franchisor or its agent, from which a specific level or range of actual or potential sales, costs, income or profit from franchised or non-franchised units may be easily ascertained.
>
> A chart, table or mathematical calculation presented to demonstrate possible results based upon a combination of variables (such as multiples of price and quantity to reflect gross sales) is an earnings claim subject to this item.

UFOC Guidelines, Item 19 Instructions, i.

[96] This would streamline the current Rule, which addresses historical performance representations and projections in two distinct Rule provisions, 16 C.F.R. §§ 436.1(b) (projections) and 436.1(c) (historical information).

[97] The staff has adopted the same position in informal advisory opinions. *E.g.,* Handy Hardware Centers, Bus. Franchise Guide (CCH) ¶ 6,426 (1980) (The Rule's "earnings claim requirements are application to 'any oral, written, or visual representation.'"); Diet Center, Inc., Bus. Franchise Guide (CCH) ¶ 6,437 (1983) (table with arithmetic calculations uniformly demonstrating net profits constitutes a financial performance representation).

Rule's requirements for general media performance representations should extend to representations made via the Internet. We address each of these issues below.

a. Implied representations

As noted above, the NPR's proposed definition of "financial performance representation" would capture implied performance representations by retaining the currently used word "suggests." According to Howard Bundy, a franchisee advocate, the "suggests" language in the definition of "financial performance representation" is flawed: it would not address the furnishing of fragments of financial data from which a prospect may readily estimate or calculate earnings. He would add language such as "or from which a prospective franchisee could readily estimate or calculate" following the word "suggests." Bundy, Comment 18, at 1.

The staff agrees that this part of the NPR's proposed "financial performance representation" definition could be more precise. There is no doubt that a franchisor can imply that a prospect can earn a specific level of income, such as by using a proxy for earnings (for example, "You will do so well that you can buy that Porsche.").[98] A franchisor can also imply a performance claim by giving a prospect a few pieces of financial information from which the prospect can fill in the blanks and draw his or her own conclusion about a specific level of potential earnings.[99] We believe both types of implied claims constitute financial performance representations that are, and should be, covered by the Rule. To clarify this policy, the staff recommends that the Commission replace the word "suggests" currently used in the Rule with the more precise phrase "states, expressly or by implication," language that is widely used, for example, in franchise and related Section 5 matters.[100]

b. Expense information

One area where the NPR's proposed definition of "financial performance" would differ from the comparable UFOC Guidelines' definition is the exclusion of expense or cost information. In the NPR, the Commission proposed that a franchisor's dissemination of expense

---

[98] *See* Final Interpretive Guides, 44 Fed. Reg. at 49,982.

[99] *Id.*

[100] *See, e.g., FTC v. Advanced Pub. Communications Corp.*, 00–00515 CIV-Ungaro-Benages (S.D. Fla. 2000) (charging defendants with representing, expressly or by implication, that purchasers of their opportunity would earn in excess of $300 per payphone per month); *FTC v. Innovative Prods.*, 3:00-CV-0312-D (N.D. Tex 2000) (charging defendants with representing, expressly or by implication, that purchasers of their opportunity would earn a substantial amount of money after sending in a registration fee); *FTC v. Star Publ'g Group, Inc.*, 00CV 023D (D. Wyo. 2000) (charging defendants with representing, expressly or by implication, that purchasers of their refund tracer opportunity would earn substantial income).

information alone should not be deemed the making of a financial performance claim.[101] At the same time, the NPR raised the concern that some might draw the conclusion that the required disclosure of expense information in Items 5-7 of the Rule (initial fees and initial investment) could be interpreted as implying a performance claim, such as a break-even point, thereby compelling the franchisor to prepare an Item 19 financial performance disclosure. To remove any doubt that expense information alone does not constitute a financial performance representation, the Commission proposed excluding expense information from the "financial performance" definition. The Commission, however, questioned: (1) whether the omission of expense information is sufficient to clarify that compliance with the Rule's expense disclosure obligations would not trigger the Rule's Item 19 obligations; and (2) whether the proposed definition could inadvertently enable franchisors to make "back-door" financial performance representations by casting such representations as additional expense information.[102]

Most commenters who addressed this issue supported eliminating expense information from the definition of financial performance information.[103] Some, however, sought additional clarification. For example, the IL AG urged the Commission to modify the proposed definition of "financial performance representation" expressly to exclude Items 5-7 expense information, offering the following additional sentence: "Expenses required in Items 5, 6, and 7 of the disclosure document are not to be considered performance claims and do not contradict Item 19 requirements." IL AG, Comment 3, at 8-9.[104] Others would go further, arguing that the dissemination of any expense information should not trigger the Item 19 disclosure requirements.[105]

---

[101] 64 Fed. Reg. at 57,328-29. This approach would change the Commission's original policy. In the Final Interpretive Guides, the Commission took the position that cost information alone could be a financial performance claim because a prospective franchisee could use such information to calculate likely profits by simply selecting arbitrary sales figures. 44 Fed. Reg. at 49,982.

[102] 64 Fed. Reg. at 57,328-29.

[103] *E.g.,* IL AG, Comment 3, at 8-9; Baer, Comment 11, at 7; NFC, Comment 12, at 13; NASAA, Comment 17, at 2; BI, Comment 28, at 10. *But see* Bundy, Comment 18, at 2 (arguing that expense disclosures inevitably will lead prospective franchisees to extrapolate earnings, without the protection of an Item 19 disclosure).

[104] *See also* Baer, Comment 11, at 7.

[105] NFC, Comment 12, at 13. The NFC also suggested that the Commission modify the Rule to exclude from the definition of "financial performance representation" financial data furnished to existing franchisees. "[E]xisting franchisees' experience, prior investment and routine communications with other franchisees suggests that their franchisor's dissemination of what would otherwise be illegal financial performance representations would result in no harm to such franchisees but could actually be of significant help." *Id.* The NFC contended that existing

NASAA and BI added that excluding expense information is not likely to lead to back-door earnings claims. NASAA, for example, observed that "franchisors that make unlawful representations of financial performance generally make representations about earnings and rarely limit their representations to expense information alone." NASAA, Comment 17, at 2. BI further observed that any franchisor who uses cost or expense information to imply earnings would fall under the ambit of the Rule's implied financial performance claim.[106]

In light of these comments, the staff recommends that the Commission eliminate references to expense information from the definition of the term "financial performance representation." The experience of NASAA's members tends to confirm that franchisors do not routinely disseminate expense information to prospects. Moreover, we are persuaded that expense information alone is insufficient to enable prospects to gauge their potential earnings with any degree of specificity. Therefore, when compared with gross or net revenue data, for example, expense information is not likely to mislead prospective franchisees about their potential success or risk in purchasing a franchise. To avoid any possible confusion in this area, we further recommend that the Commission make clear in the Compliance Guides that the Rule's cost disclosures (Items 5-7) alone do not constitute the making of a financial performance representation.

c. General media and Internet representations

The current Rule also governs the making of financial performance representations in the general media. Like other financial performance claims, a general media claim must have a reasonable basis and state the number and percentage of outlets earning the claimed amount, among other substantiation and disclosure requirements.[107] A general media claim, however,

---

franchisees would be protected because misrepresented financial performance claims still violate Section 5. *Id.*

We believe that the Rule need not be revised to address this issue. A franchisor is always free to furnish truthful information about its system to existing franchisees, especially if no additional franchise sale is contemplated. If, however, the franchisor contemplates an additional franchise sale under materially different terms and conditions than the franchisee's original purchase, then the existing franchisee, like any prospective franchisee, could be misled and therefore should receive financial performance disclosures in the form of an Item 19. For example, an Item 19 will assist an existing franchisee operating in a shopping mall or urban area in the northeast to understand an earnings projection for an additional stand-alone outlet or outlet to be located in a rural section of the southwest.

[106] BI, Comment 26, at 10.

[107] *See* 16 C.F.R. §§ 436.1(b)(5)(i); 436.1(c)(6)(i); 436.1(e)(5)(ii).

need not be geographically relevant to the market in which franchises are being offered for sale.[108] There is no comparable provision in the UFOC Guidelines.[109]

In the NPR, the Commission proposed updating the Rule by clarifying that the definition of financial performance representations covers general media representations, including those representations made via the Internet.[110] The majority of commenters who addressed this issue questioned whether online financial performance representations should be considered general media claims.[111] These commenters asserted that the Commission should not deem financial performance information on a franchisor's Web site to be representations directed at prospective franchisees, unless the information is located in a section of a Web site that solicits franchise purchases or otherwise specifically targets prospective franchisees.[112] In their view, financial performance information on a franchisor's Web site – including links to press releases, interviews, or articles – is intended to educate the general public about the company, rather than to attract prospective franchisees.[113] Indeed, some posted information may consist of copies of publicly filed reports, such as 10-Qs and 10-Ks, that are submitted to the Securities and Exchange Commission ("SEC").[114] At least one commenter feared that equating online financial performance representations with general media representations would have a chilling effect, unreasonably restricting the kinds of materials a franchisor could have on its Web site: "Does this mean that a franchise company, unlike any other business, must choose between taking advantage of articles or press releases about itself on its own web site page or risk the claim that a prospective franchisee has been given unauthorized non-Item 19 financial data?" Quizno's, Comment 1, at 3.

---

[108] *See id.* at § 436.1(e).

[109] Although the UFOC Guidelines do not address general media claims, many of the states with disclosure laws require franchisors to register their advertisements in advance of their use. *E.g.*, Cal. Corp. Code § 31156 (1997) (franchisor must register advertising at least three business days before first publication); Md. Code Ann., Bus. Reg. § 14-225 (1998) (franchisor must register advertising at least seven business days before publication).

[110] 64 Fed. Reg. at 57,297.

[111] *E.g.,* PMR&W, Comment 4, at 16; H&H, Comment 9, at 14; NFC, Comment 12, at 23-24.

[112] *E.g.,* Quizno's, Comment 1, at 3; PRM&W, Comment 4, at 16; NFC, Comment 12, at 24; BI, Comment 28, at 9.

[113] *E.g.,* Quizno's, Comment 1, at 3. *See also* BI, Comment 28, at 9.

[114] *E.g.,* Quizno's, Comment 1, at 3; PMR&W, Comment 4, at 16; H&H, Comment 9, at 14; BI, Comment 28, at 9.

The staff believes the proposition that general media representations may include Internet representations is sound.[115] First, online performance representations fit squarely in the current definition of "general media." The current general media claims provision is broad, covering any "oral, written, or visual representation for general dissemination." 16 C.F.R. § 436.1(e). Further, a general media claim is not limited to advertising. Indeed, the Commission stated that general media claims include not only advertising (radio, television, magazines, newspapers, billboards, etc.), but also statements made in speeches or press releases.[116] The only stated exceptions are for "communications to financial journals or the trade press in connection with bona fide news stories, or directly to lenders in connection with arranging financing for the franchisee." Final Interpretive Guides, 44 Fed. Reg. at 49,984-85. Accordingly, it is clear that under the current Rule general media is a broad concept, encompassing more than just promotional materials specifically aimed at prospective franchisees.[117] If not, a franchisor could always skirt the Rule's Item 19 protections by simply releasing performance data to the public.

Second, we see no reason to distinguish between the Internet and other forms of media. Specifically, a franchisor's Web site is indistinguishable from a company speech or press release. Both offer information designed to educate the public about the company. A franchisor may publish its own newsletter or series of press releases to disseminate such information, or a company may choose to do so through a Web site. Either way, the franchisor cannot control who will have access to the information once it is released. Indeed, an argument can be made that posting information on a general Web site (as opposed to an Intranet or other restricted or protected site) is even more of a public dissemination than a speech or press release because a general Web site is readily accessible to anyone who surfs or searches for information on the particular company, including prospective franchisees.[118]

While we believe the Internet is a form of general media, we recognize the commenters' concerns about publicly filed reports required by the SEC. We agree that such filings are already publicly available and, more important, have indicia of reliability. Indeed, the dissemination of

---

[115] This would include other electronic financial performance representations such as those in unsolicited commercial email, and banner or "pop-up" ads.

[116] Final Interpretive Guides, 44 Fed. Reg. at 49,984-85.

[117] Further, the Rule permits a franchisor to disseminate truthful information to a prospective franchisee outside of a disclosure document provided that such information does not contradict statements made in the disclosure document itself. 16 C.F.R. § 436.1(f). Clearly, a franchisor Web site containing performance data would contradict an Item 19 that said nothing.

[118] In many instances, a Web site is also longer-lasting than an isolated news release. A prospective franchisee surfing the Internet has the potential of retrieving archives of company releases and speeches, which otherwise would not be readily available. Such information, in aggregate, may induce reliance more than an isolated release or speech.

false financial data statements could lead to shareholder suits. We also agree that in some instances the dissemination of financial data online is for the benefit of investors and the general public, not for prospective franchisees.[119]

To address this issue, we propose a balanced approach. First, we recommend that the Commission delete the proposed reference to the Internet from the definition of financial performance representation. We believe a blanket reference to the Internet would be too broad, sweeping in all online financial data within the definition of a financial performance representation, even those not aimed at prospective franchisees. Rather, we believe the Commission should explain the relationship between general media claims and the Internet in the Compliance Guides, where the issue can be more fully addressed with appropriate examples.

Second, we recommend that the Commission retain and expand the exclusions from general media claims currently set forth in the Final Interpretive Guides[120] to include financial data filed with the SEC. Specifically, we recommend that the Commission make clear in the Compliance Guides that franchisors will not be deemed to make a financial performance claim merely by posting online a press release about its financial status or other financial data filed with the SEC. However, where a franchisor uses such data as a marketing tool for the sale of franchises, it will be deemed to have made a general media claim.[121]

---

[119] Indeed, the staff has previously advised that the dissemination of financial data through bona fide news stories may generate benefits to the public that outweigh potential harm to prospective franchisees. "For example, such information may be useful to potential suppliers seeking growing businesses as customers; shopping center or mall developers seeking promising franchised systems as tenants; and financial analysts who follow market or industry trends. Accordingly, the exemption from the general media earnings claims disclosure requirements ensures that the Rule does not chill the free flow of newsworthy information about franchising or particular franchise systems." Advisory 97-5, Bus. Franchise Guide (CCH) ¶ 6485 at 9687 (July 31, 1997).

[120] 44 Fed. Reg. at 49,984-85 ("'General media claim' does not include communications to financial journals or the trade press in connection with bona-fide news stories, or directly to lenders in connection with arranging financing for franchisees.").

[121] Franchisors could easily avoid making a general media claim by restricting its posting of SEC filings to its Web site's investor information page. In contrast, a franchisor that places such filings, or provides links to such filings, on its franchise offering section would be deemed to make a general media claim. *See* Advisory 97-5, Bus. Franchise Guide (CCH) at 9687 ("By disseminating copies of [news articles containing earnings claims], the franchisor effectively ratifies the journalist's words at its own and, in so doing, converts the article into an advertising piece designed to solicit prospective franchisees."). In other scenarios, we believe the franchisor takes the risk that its financial information might be deemed a general media claim. Such determination can be made only on a case-by-case basis, with the primary consideration being

In summary, we recommend that the Commission address the issues of implied representations, expenses, and general media claims[122] by adopting the following definition of "financial performance representation":

> *Financial performance representation* means any oral, written, or visual representation to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits.[123] A chart, table, or mathematical calculation that shows possible results based on a combination of variables is a financial performance representation.

---

whether, given all the facts, the financial information is disseminated for the benefit of prospective franchisees. If so, the posting must contain the disclosures for general media claims and the franchisor must include an Item 19 financial performance claim in its disclosures.

[122] We further recommend that the Commission take the opportunity to clarify in the Compliance Guides the relationship between the making of general media claims and Item 19 disclosure obligations. Consistent with the current Rule, the revised Rule would require a franchisor making a general media claim to include that claim, as well as the bases and assumptions (among other substantiation) in the disclosure document. However, there currently exists no guidance on compliance, such as what happens if the franchisor stops running an advertisement or changes the claims made in an advertisement. We believe the Compliance Guides should make clear that a franchisor running an advertisement containing financial performance claims must make the required disclosures at the very least while the advertisement is running. If a franchisor stops running the advertisement and makes no additional claims, it nonetheless must continue to make disclosures for a reasonable period of time, not less than six months. Where a franchisor replaces an advertisement with a new one containing updated financial information, the franchisor may provide the updated information in its disclosure documents. Updated information is clearly more relevant to a prospective franchisee than older, possibly stale, information. Finally, where a franchisor runs multiple advertisements containing different types of financial performance claims, we would expect the franchisor to disclose and provide documentation for each type of claim in its Item 19.

[123] We also recommend that the Commission make clear in the Compliance Guides that the term "general media" includes other forms of electronic online advertising such as unsolicited commercial email and banner or "pop-up" advertising.

E. Proposed Section 436.1(g): Fractional franchise

1. Background

A fractional franchise is one of several franchise relationships currently exempted from the Rule.[124] In most instances, the fractional franchise exemption arises where an existing business seeks to expand its product line through a franchise relationship with a manufacturer. The exemption is available if the franchisee has two years of experience in the same business and its sales from the new line of business do not exceed 20% of its total sales.[125]

In the NPR, the Commission proposed retaining, but modifying, the current definition of fractional franchise. Specifically, the NPR proposed that the definition incorporate the Commission's long-standing policy that the parties must anticipate that the additional sales will not exceed 20% of total sales within the first year of operation. It would also make explicit what previously has been only implied: that the parties must have a reasonable basis to assert the exemption.[126]

2. The record and recommendations

In response to the NPR, three commenters recommended changes to the definition of fractional franchise. H&H suggested that the Commission broaden the first prong – "experience in the same type of business" – to exempt franchisees with experience selling similar or

---

[124] *See* 16 C.F.R. § 436.2(a)(3)(i). The term "fractional franchise" is defined in the current Rule at § 436.2(h) as:

> any relationship . . . in which the person described therein as a franchisee, or any of the current directors or executive officers thereof, has been in the type of business represented by the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would represent no more than 20 percent of the sales in dollar volume of the franchisee.

[125] In the Statement of Basis and Purpose ("SBP") accompanying the Rule, the Commission recognized that pre-sale disclosure is unwarranted where the prospective franchisee already is familiar with the products and services to be sold through the franchise and where the prospective franchisee faces a minimal investment risk. 43 Fed. Reg. 59,614, 59,707 (Dec. 21, 1978).

[126] 64 Fed. Reg. at 57,297. *See also* Final Interpretive Guides, 44 Fed. Reg. at 49,968.

complementary goods or services.[127] J&G would broaden the exemption further. Focusing on the second prong of the exemption, the firm recommended that any franchise arrangement that accounts for less than 25% of the franchisee's business in the next year should be exempt from the Rule, regardless of the products or services previously sold.[128] Third, Tricon urged the Commission to clarify how franchisors should calculate a potential fractional franchisee's total dollar volume in sales. Tricon noted that a fractional franchisee's total sales could be calculated in one of four ways. Specifically, the increase in product sales attributed to the fractional franchise relationship could be measured against: (1) the fractional franchisee's total sales for that type of product; (2) the fractional franchisee's total sales at the store where the new product is sold; (3) the fractional franchisee's total sales at all franchised units; or (4) the fractional franchisee's total sales from all businesses (franchise and non-franchised), regardless of the source.[129]

For the following reasons, the staff recommends that the Commission adopt the fraction franchise definition, as proposed in the NPR. First, we believe the suggestion that fractional franchises include the sale of complementary goods goes too far. The current requirement that a fractional franchisee have prior experience in the same line of business reduces the likelihood of fraud because the fractional franchisee will likely be familiar with the products to be offered for sale through the franchise relationship. As explained in the Interpretive Guides, "the required experience may be in the same business selling competitive goods or in a business that would ordinarily be expected to sell the type of goods to be distributed under the franchise." 44 Fed. Reg. at 49,968. Thus, the Commission does not require experience in the "identical type of business"; rather, the sale of similar goods may qualify for the exemption. This approach is reasonable because a prospective franchisee who is already familiar with the goods or services of the franchise can better assess the financial risk involved in entering into a relationship with the franchisor.

The analysis, however, may not be the same for complementary goods. What may be viewed as "complementary goods" in any particular line of business may be quite subjective. For example, reasonable minds may differ whether the introduction of ice cream sales at a donut/coffee shop is "complementary." While certain products make complementary sales combinations – such as ice cream and donuts – it does not necessarily follow that a donut shop franchisee is experienced with the risks involved with marketing and selling ice cream. H&H has offered no definition of "complementary" that would ensure the requisite knowledge, nor do we believe such a definition is available.

---

[127] H&H, Comment 9, at 4.

[128] J&G, Comment 32, at 3.

[129] Tricon, Comment 34, at 2-3.

Second, we also reject J&G's suggestion that the fractional franchise exemption focus exclusively on the second prong – the franchisee's level of investment. As a preliminary matter, we agree that the amount a prospective franchisee can invest in a franchise is a measure of sophistication. Recognizing that, the proposed Rule sets forth a new exemption for large investments, as discussed below. The fractional franchise exemption, however, is different because it may apply where the franchisee's investment is not necessarily large. As an alternative to a large investment, the fractional franchise exemption focuses on minimal financial risk: a fractional franchisee will be exempt from the Rule where his or her financial risk is minimal both because the investment represents only a small part of expected income and because of prior experience in the field.[130] We believe this is a sound approach. Accordingly, we recommend that the fractional franchise exemption retain the prior experience prerequisite.

Finally, we agree with Tricon that the current Rule does not sufficiently explain how to calculate total sales for purposes of the fractional franchise exemption. As noted above, the exemption's minimum sales threshold for new products or services better ensures that the fractional franchisee faces only a minimal financial risk. In that light, we believe that it is proper for the parties to measure incremental sales resulting from the fractional franchise against total sales at all stores owned by the franchisee (franchised or non-franchised). For example, an individual owning several hardware stores may introduce a new product at one store only. The store owner, in our view, should measure the increase in sales attributed to the new product against the aggregate total sales volume for all products sold through his or her businesses. We propose that the Commission include this explanation of the fractional franchises' second prong in the Compliance Guides that will accompany the revised Rule.

F. Proposed Section 436.1(h): Franchise

1. Background

Currently, the Franchise Rule defines "franchise" broadly to encompass both franchises and business opportunity ventures. A franchisor is covered by the Rule if the franchisor satisfies the following three elements: (1) permits the use of its trademark; (2) imposes significant control over the franchise operation or provides significant assistance to the franchisee; and (3) charges a required payment.[131] A business opportunity is also be covered by the Rule if the seller satisfies these three elements: (1) the seller or an affiliate supplies the buyer with goods or services to

---

[130] In the alternative, an individual prospective franchisee conducting business as an entity could qualify for the proposed large franchisee exemptions, as discussed below at section IX.B.3.c.

[131] 16 C.F.R. §§ 436.2(a)(1)(i) and 436.2(a)(2). The UFOC Guidelines do not define what constitutes a franchise. Rather, definitions of the term "franchise" are set forth in individual state statutes. For a discussion of state definitions of the term "franchise," see section IV.F.2.a, below.

market to the public; (2) provides location assistance or accounts for vending machines or other equipment; and (3) charges a required payment.[132]

In the NPR, the Commission proposed a revised definition of "franchise" that would focus exclusively on franchise sales. In light of the NPR's recommendation to create a separate trade regulation rule for business opportunity sales,[133] a narrower definition is necessary to ensure that ordinary business opportunities no longer fall within the Franchise Rule's purview. Specifically, the NPR proposed narrowing the definition by focusing on the second element of the definition – significant control or assistance.[134] The franchisor would have to exert or have the authority to exert significant "*continuing* control" over the franchisees' method of operation.[135] In the alternative, the franchisor would have to offer significant assistance "*extending beyond the start of the business operation*."[136] These modifications would clarify the distinction between franchises and business opportunities, where any control or assistance is typically limited to the initial phase of the business.

In addition to eliminating business opportunities from the definition of "franchise," the NPR also proposed updating the Rule by incorporating two long-standing Commission policies.[137] First, a relationship will be deemed a franchise if it meets the three elements of a franchise, regardless of whatever it may be called.[138] Second, a business relationship will be

---

[132] 16 C.F.R. §§ 436.2(a)(1)(ii) and 436.2(a)(2).

[133] *See* 64 Fed. Reg. at 57,296.

[134] *Id.* at 57,297. As part of our overall effort to streamline the Rule, we also recommend eliminating one alternative element of the current definition of "franchise," namely 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*). As discussed in the NPR, quality standards are simply one type of control that a franchisor may impose on a franchisee. As long as the Rule retains a broad "control" element, the more specific "quality standards" alternative is unnecessary. *Id.* at 57,298.

[135] *Id.* at 57,297.

[136] *Id.* at 57,298.

[137] We also recommend that the Rule adopt the Commission's policy that the "payment" element can be satisfied either by contract or by practical necessity. However, as discussed below at section IV.O., we recommend that this policy be included in the definition of "required payment," rather than in the definition of "franchise."

[138] *See* Final Interpretive Guides, 44 Fed. Reg. at 49,966. *See also FTC v. Marrone's Water Ice, Inc.,* No. 92-3720 (E.D. Pa. 2002). The staff has provided the same advice in several informal advisory opinions. *E.g.,* Con-Wall Corp. Bus. Franchise Guide (CCH) ¶ 6,427 (1981).

deemed a franchise if it is offered or represented as having the characteristics of a franchise, regardless of any failure on the franchisor's part to perform as promised.[139]

2. The record and recommendations

In response to the NPR, no commenters objected to narrowing the definition of franchise to eliminate coverage of business opportunities. However, the proposed definition generated four suggestions: (1) the Commission should adopt the states' definition of "franchise"; (2) the Commission should fine-tune the second definitional element – "significant control and assistance"; (3) the Commission should fine-tune the third definitional element – required payment; and (4) the Commission should reconsider its policy concerning business relationships represented as having the characteristics of a franchise. Below, we address each of these suggestions.

a. State definitions of franchise

John Baer suggested that the Commission abandon the proposed definition of franchise in favor of one commonly used by the states, pointing to California's definition as a model.[140] We reject this suggestion.

We begin by noting that the definition of "franchise" has been used by the Commission for over 20 years and is well known in the franchise community, especially in the 35 states without any franchise pre-sale disclosure statute. Moreover, there is no single state definition of the term "franchise." The states define "franchise" in basically two ways: some refer to selling goods or services according to a marketing plan,[141] while others refer to a community of interests

---

[139] SBP, 43 Fed. Reg. at 59,699-70. *See also U.S. v. Protocol, Inc.,* Bus. Franchise Guide (CCH)[1996-97 Transfer Binder], ¶ 11,184 at 29,550, 29-555 (D. Minn. 1997); *FTC v. Wolf,* 1996 WL 812940, *7n.2; *FTC v. Int'l Computer Concepts*, 1994-2 Trade Cases, ¶ 70,798 at 73,403; *FTC v. Sage Seminars, Inc.,* 1995 WL 798938, *7 (N.D. Cal). Commission staff has provided the same advice in several informal advisory opinions. *E.g.,* Real America Real Estate Corp., Bus. Franchise Guide (CCH) ¶ 6,428 (1982) ("the applicability of the rule will not be defeated by a franchisor's subsequent failure to live up to any such commitment.").

[140] Baer, Comment 11, at 7. *See generally* Cal. Corp. Code §§ 31000-31516 (1997).

[141] *See* Cal. Corp. Code at § 31005(a)(1); 815 Ill. Comp. Stat. 705/3(1)(a) (1999); Ind. Code Ann. § 23-2-2.5-1(a)(1) (1999); Md. Code Ann., Bus. Reg. § 14-201(e)(1)(i); Mich. Comp. Laws § 445.1502(3)(a) (1989); N.D. Cent. Code § 51-19-02.5.a(1) (1999); Or. Rev. Stat. § 650.005(4)(a)(2001); R.I. Gen. Laws § 19-28.1-3(7)(i)(A) (1998); Va. Code Ann. § 13.1-559A(b)(1)(2001); Wash. Rev. Code § 19.100.010(4)(a)(i) (1999); Wis. Stat. Ann. § 553.03(4)(a)(1) (1998). In New York, a business will also be deemed a franchise even though there is no marketing plan if a franchisee is permitted to sell trademarked goods or services.

in the marketing of goods or services.[142] Even within these two broad categories, there are differences. California, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, and Virginia define "franchise" in relevant part as: "A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services at retail under a marketing plan or system prescribed in substantial part by a franchisor."[143] On the other hand, Illinois, Rhode Island, Washington, and Wisconsin have adopted a broader definition, modifying the sentence above to read: "a marketing plan or system prescribed *or suggested* in substantial part by a franchisor."[144] There are other differences as well. Some states require the payment of any franchise fee,[145] while others require a payment of at least $500.[146] Oregon requires the franchisee to pay "valuable consideration."[147] States also differ regarding the trademark requirement. New York, for example, does not require the use of a trademark at all. Rather, a business arrangement will constitute a franchise if either the franchisor offers a marketing plan or permits the sale of trademarked goods or services. In Hawaii, Minnesota, and South Dakota, it is sufficient for a franchisor to grant the franchisee the right to use the franchisor's trademark.[148] In

---

N.Y. Gen. Bus. Law, § 681(3)(a) (1996) (marketing plan) or § 681(3)(b) (trademarked goods or services).

[142] Haw. Rev. Stat. Ann. § 482E-2 (1998); Minn. Stat. § 80C.01.4(2) (1999); S.D. Codified Laws, § 37-5A-1(2) (2000).

[143] Cal. Corp. Code at § 31005(a)(1); Ind. Code Ann. at § 23-2-2.5-1(a)(3); Md. Code Ann., Bus. Reg. § 14-201(e)(1)(i); Mich. Comp. Laws § 445.1502(3)(a); N.Y. Gen. Bus. Law, § 681(3)(a) (1996); N.D. Cent. Code § 51-19-02.5.a(1); Or. Rev. Stat. § 650.005(4 a); Va. Code Ann. § 13.1-559A(b)(1).

[144] 815 Ill. Comp. Stat. at § 705/3(1)(a); R.I. Gen. Laws § 19-28.1-3(7)(i)(A); Wash. Rev. Code § 19.100.010(4)(a)(i); Wis. Stat. Ann. § 553.03(4)(a)(1).

[145] Cal. Corp. Code at § 31005(a)(3); Haw. Rev. Stat. Ann. at § 482E-2; Ind. Code Ann. § 23-2-2.5-2(a)(3); Md. Code Ann., Bus. Reg. § 14-201(e)(iii); Mich. Comp. Laws § 445.1502(3)(c); Minn. Stat. § 80C.01(4)(3); N.Y. Gen. Bus. Law, § 681(3)(b); N.D. Cent. Code § 51-19-02.5.a(1); S.D. Codified Laws § 37-5A-1(3); Wash. Rev. Code § 19.100.010(4)(a)(iii); Wis. Stat. Ann. § 553.03(4)(a)(3).

[146] 815 Ill Comp. Stat. at § 705/3(1)(c); R.I. Gen. Laws § 19-28.1-3(7)(B); Va. Code Ann. § 13.1-559(b)(3).

[147] Or. Rev. Stat. § 650.005(4)(c).

[148] Haw. Rev. Stat. Ann. at § 482E-2; Minn. Stat. § 80C.01(4)(1); S.D. Codified Laws, § 37-5A-1(1).

the other states, the franchisee must sell goods "substantially associated" with the franchisor's trademark.[149]

At the same time, we note that the Rule's use of the terms "control" and "assistance" is not dissimilar from the majority of the states' "marketing plan or prescribed system" approach. A marketing plan or prescribed system is essentially a series of controls that enable investors to operate a business under uniform standards. For example, in its interpretation of the California Franchise Act, the California Department of Corporations states:

> Control reserved over terms of payment by customers, credit practices, warranties and representations in dealings between franchisees and their customers, suggest a uniform marketing plan. Provisions concerning collateral services, which may or may not be rendered, or prohibiting or limiting the sale of competitive or non-competitive goods are consistent with, though certainly not in and of themselves determinative of, a prescribed marketing plan. Significance attaches to provisions imposing a duty of observing the licensor's directions or obtaining the licensor's approval with respect to selection of locations, the use of trade names, advertising, signs, sales pitches, and sources of supply, or concerning the appearance of the licensee's business premises and the fixtures and equipment utilized therein, uniforms of employees, hours of operation, housekeeping, and similar decorations.

California Department of Corporations, Release 3-F (Revised) at B(2)(c) (June 22, 1994) ("CA Release 3-F"), reprinted at www.corp.ca.gov/commiss/rel3f.htm.

Further, we believe the reference to "assistance" is necessary in those situations where franchisors, especially low-cost franchisors, do not sell a prescribed plan or impose system standards on their franchises.[150] Rather, they focus on the offer of assistance in order to attract

---

[149] Cal. Corp. Code at § 31005(a)(2); 815 Ill. Comp. Stat. at § 705/3(1)(b); Ind. Code Ann. at § 23-2-2.5-1(a)(2); Md. Code Ann., Bus. Reg. § 14-201(e)(ii); Mich. Comp. Laws § 445.1502(e)(b); R.I. Gen. Laws § 19-28-1-3(7)(C); N.D. Cent. Code § 51-19-02.5.a(2); Or. Rev. Stat. § 650.005(4)(b); Va. Code Ann. § 13.1-559(b)(2); Wash. Rev. Code § 19.100.010(4)(a)(ii); Wis. Stat. Ann. § 553.03(4)(a)(2).

[150] The Staff Review found franchisee complaints about the lack of promised support, training, and other support problems generated 39 complaints, while no complaint addressed the lack of system controls. *See* Staff Review at 25. Similarly, misrepresentations about promised assistance are the fourth most common complaint allegation (17 allegations) in Commission franchise and business opportunity cases, after earnings claims (94 allegations), false testimonials or references (28 allegations), and location misrepresentations (24 allegations). *Id*. at 39. In contrast, the Commission has never brought a case in which the franchisor misrepresented its control over the system or the nature of system standards.

prospective franchisees, especially individuals without prior business experience.[151] In the SBP, the Commission recognized that the original rulemaking record strongly supported the inclusion of an alternative "assistance" element in the definition of "franchise," stating:

> While a franchise agreement may expressly reject the franchisor's right to control the methods of operation of the franchisee, the franchisee may as a practical matter remain entirely dependent on the franchisor's direct "assistance." In a "control" situation, the franchisor reduces the franchisee's risk of doing business, simply by directing the franchisee's actions. In an "assistance" agreement, the franchisor reduces the franchisee's risk of doing business by training or otherwise assisting the franchisee to make the right business decisions. In both cases, the franchisee is dependent on the franchisor's superior knowledge and expertise.

SBP, 44 Fed. Reg. at 59,702 n. 43.[152]

Apparently, the states agree, recognizing that a franchise may be found on the basis of assistance. For example, California recognizes a "marketing plan prescribed by implication":

> A marketing plan or system may be "prescribed" . . . where a specific sales program is outlined, suggested, recommended, or otherwise originated by the franchisor. Thus, a sales program may be "prescribed" by the franchisor where the franchisor supplies the franchisee with sales aids or props, such as demonstration kits, films, or detailed instructions for personal introduction and presentation of the product, possibly including the text of a sales pitch and especially where such a program is supported by training materials, courses, or seminars.

CA Release 3-F at B(2)(e). Other states, as noted above, address assistance indirectly by adding the word "suggested" to their franchise definition: "a marketing plan or system prescribed or suggested in substantial part by a franchisor." In short, we see little substantive difference between the Rule and state approaches. Accordingly, we recommend that the Commission address these issues directly by using the words "control" and "assistance," consistent with the current Rule.

---

[151] *See, e.g., U.S. v. Lifecall Sys. Inc.,* No. 90-3666 (D. N.J. 1990); *FTC v. McKleans, Inc.,* Bus. Franchise Guide (CCH), ¶ 9853 (D. Conn. 1989); *FTC v. The Kis Corp.*, No. C88-1494 (D. Wash. 1983). The inclusion of an assistance element in the Rule is substantially similar to the minority of states whose franchise laws include prescribed or *suggested* marketing plans, as explained above.

[152] *See also* SBP, 43 Fed. Reg. at 59,701 n. 37 (commenters suggesting that the franchise definition reference control and assistance).

The current Rule and state approaches are also similar regarding the trademark element. As previously noted, the current Rule uses the phrase "identified or associated with" the franchisor's mark. This is similar to the states that require that the franchisee obtain the right to use the franchisor's mark. For example, a service-oriented franchise operated out of a home, as opposed to a storefront, might not have a sign with the franchisor's logo, or unique uniforms associated with the franchisor. Although the franchisee's "association" with the franchisor's mark may be limited (such as the right to use the franchisor's mark on business cards, advertising, and in yellow page listings), it is sufficient to trigger the Rule's disclosure obligations: in such circumstances, the use of the franchisor's trademark leads consumers to identify the business with the franchisor. Even California, which uses the phrase "substantial association" with the mark, recognizes that the grant of permission to use a franchisor's trademark in the operation of a business would constitute "substantial association" with the mark.[153]

Finally, we note that adopting a "substantial association" criterion – as Mr. Baer seems to suggest – might unnecessarily impose a new burden of proof in Commission law enforcement actions. Not only would the Commission have to show that the franchisor granted a prospective franchisee the right to use its trademark, but that the trademark use was "substantial." We believe this construction goes too far. For these reasons, we believe the Commission should retain its definition of the term "franchise," as modified below.

b. Significant control and assistance

Several commenters addressed the second definitional element – significant control or assistance. BI suggested that the "franchise" definition should include the Commission's policy, as stated in the Interpretive Guides, that assistance and control must relate to the entire business operation.[154] John Baer recommended that significant assistance, like "control," ought to be continuing.[155] The NFC would substitute the word "influence" for "control," maintaining that the word "control" implies vicarious liability for franchisee actions.[156]

---

[153] *See* CA Release 3-F at 3 ("[I]f the franchisee is granted the right to use the franchisor's symbol, that part of the franchise definition is satisfied even if the franchisee is not obligated to display the symbol.").

[154] BI, Comment 28, at 1.

[155] Baer, Comment 11, at 9.

[156] NFC, Comment 12, at 26 ("[T]he federal government's defining a franchise relationship as one in which the franchisor 'exerts or has authority to exert a significant degree of continuing control of the franchisee's method of operation' can only create vicarious liability mischief for franchisors where none was intended.").

We agree with BI that control and assistance must relate to the franchisee's overall business operation. This is consistent with long-held Commission policy.[157] However, we decline to incorporate the term "entire method of operation" into the Rule's franchise definition. Read literally, it would require control by the franchisor over every conceivable aspect of the business operation. In other words, every franchisor could avoid Rule coverage simply by not controlling one aspect of the business. Rather, we believe that the Commission meant that control must be over a substantial portion of the franchisee's business. We recommend that the Commission make this point clear in the Compliance Guides.

Upon further reflection, we also believe that the NPR's proposed language "significant assistance extending beyond the start of the business operation" is too broad, unintentionally sweeping in some business opportunities that provide services beyond just the initial start-up period, such as providing locations or supplies on a long-term basis. In short, when a promoter furnishes promised assistance is not necessarily helpful in distinguishing between franchises and business opportunities. We recommend, therefore, that the Commission retain the original Rule's "significant assistance" language, but provide in the Compliance Guides examples of what is and is not significant. In short, significant control has a quantitative and qualitative component: to be "significant," control must cover a substantial portion of the franchisee's business operation, as noted above, and it must be the type of assistance that is material to a prospective franchisee. For example, absent the presence of other controls or assistance, the following alone would not be deemed "significant": promotional assistance, location or account assistance, and equipment maintenance and/or repair assistance.[158]

Finally, we reject the suggestion that the Commission replace "control" with "influence" in the proposed definition's second element. The Commission has used the term "control" since the inception of the Rule, and we believe that term is accurate. The suggested term "influence," on the other hand, would be misleading because it connotes that a franchisor only makes suggestions to a franchisee in how to conduct business. In fact, through their contracts, many franchisors impose, not suggest, system standards, which many franchise systems rigorously enforce. We are unpersuaded that the Commission should adopt a less accurate term in the Franchise Rule in anticipation that some courts might misapply the definition in a tort law context.

---

[157] Final Interpretive Guides, 44 Fed. Reg. at 49,967 ("[I]t should be emphasized that in order to be deemed 'significant' the controls or assistance must be related to the franchisee's entire method of operation – not its method of selling a specific product or products which represent a small portion of the franchisee's business.").

[158] In addition, a franchisor's fulfillment of contractual obligations to provide inventory would not be deemed "assistance."

c. Required payment

David Gurnick raised several technical issues concerning the proposed third element, which is commonly known as the required payment element. As proposed in the NPR, the third element would read: "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." 64 Fed. Reg. at 47,332. Mr. Gurnick observed that the proposed third definitional element does not actually use the term "required payment."[159] Moreover, the indirect reference to a required payment in the NPR proposal is itself different from the "required payment" definition, which reads as follows:

> *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.

64 Fed. Reg. at 57,332. Whereas the "required payment" definition refers to the "franchisor or its affiliate," the franchise definition refers to "a person affiliated with the franchisor." Also, the "required payment" definition refers to "operation of the franchise," while the "franchise" definition refers to "operation of the business." Finally, Mr. Gurnick observed that the third definitional element would seem to capture ordinary distributorships.[160]

We agree that the third element of the franchise definition – payment – should be fine-tuned. Specifically, we agree that the definition of "franchise" should reference the term "required payment," as Mr. Gurnick suggested, and the language of the third element should be consistent with that of the required payment definition. So revised, the third element of the "franchise" definition would state:

> As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

We also agree that the third element could be interpreted to include ordinary distributorships. This was not our original intent, and we recommend that the Commission address this issue

---

[159] Gurnick, Comment 21A, at 4-5. *See also* Baer, Comment 11, at 7.

[160] Gurnick, Comment 21A, at 4-6. Mr. Gurnick did not elaborate on this point. Presumably, by not using the precise term "required payment," the proposal could be interpreted as implying that any payment, such as a voluntary payment for supplies, is sufficient to trigger the Rule. This interpretation is strengthened by the absence of an inventory exemption in both the NPR's definition of the term "franchise" and "required payment."

directly by revising the separate "required payment" definition, as discussed later, to incorporate the inventory exemption, under which many distributorship arrangements fall.[161]

d. Offers having the characteristics of a franchise

David Holmes voiced concern over the Commission's policy that a business relationship will be deemed a franchise if it is offered or represented as having the characteristics of a franchise, regardless of any failure to perform as promised on the franchisor's part.[162] He stated that a relationship should not be deemed a franchise merely because the parties call it a franchise. In short, a description of the business arrangement should not rise above the substance of the relationship.[163]

We believe that the proposed "franchise" definition correctly incorporates the Commission's policy that a franchise relationship may exist based upon the seller's representations at the time of sale. However, it is clear from the comments received that this policy is not fully understood.

The commenters correctly asserted that the Rule should not cover situations where the parties mistakenly use the term "franchise" to describe their business relationship. We agree that a business relationship constitutes a franchise only if, as represented, it satisfies the three elements of the term "franchise," and nothing in the proposed definition is to the contrary. The question is when should that determination be made. The Commission's policy merely states that whether a franchise arrangement exists shall be determined based upon the representations made to the prospective buyer at the time of sale. For example, a start-up company may seek to sell its first franchised outlet, advertising that, for a $500 fee, it will license its mark and provide significant assistance to buyers. Under these circumstances, a prospect should receive a disclosure document at the time of sale because, as represented, the business offered satisfies each of the three elements of a franchise. This is true, even if the franchisor, in fact, lied and has no ability to perform as promised, such as having no right to the trademark offered or having no staff to provide promised assistance. In short, the seller should not be able to raise as a defense to a Rule violation that it, in fact, offered a non-franchise business arrangement if, at the time of sale, its representations satisfied the definition of a franchise.

---

[161] We discuss other suggested revisions to the term "required payment" below at section IV.N of this Report.

[162] *E.g.,* Holmes, Comment 8, at 1-2. *See also* Gurnick, Comment 21A, at 5; IL AG, Comment 3, at 3.

[163] Holmes, Comment 8, at 2.

G. Proposed Section 436.1(i): Franchise seller

1. Background

In the NPR, the Commission introduced a new term – "franchise seller." This term and its definition are needed in order to delineate easily all parties having obligations under the Rule.[164] Consistent with long-standing Commission policy, the NPR's proposed definition would also make explicit that an individual franchisee seeking to sell his or her own outlet is not covered by the Rule:[165]

> 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.

64 Fed. Reg. at 57,332.

2. The record and recommendation

In response to the NPR, six commenters addressed the scope of the proposed definition of "franchise seller." Warren Lewis suggested that the definition specifically reference subfranchisors.[166] J&G commented that the definition refers to, but does not define, franchise brokers. The firm would limit the definition of brokers to individuals who: (1) are not employed by franchisors or subfranchisors; (2) are compensated pursuant to a written agreement for qualifying prospects; and (3) are active participants in the sales process.[167] The firm also proposed that the definition specifically exclude certain individuals who arguably might be

---

[164] 64 Fed. Reg. at 57,298. If adopted, this proposal would have no substantive effect. Currently, the Rule uses the terms "franchisor" and "franchise broker" throughout the Rule, and, in some instances, references employees and agents. The proposed term "franchise seller" would streamline the Rule by referencing all such individuals, where appropriate, by using only one term.

[165] *See* Final Interpretative Guides, 44 Fed. Reg. at 49,969.

[166] Lewis, Comment 15, at 8. Mr. Lewis proposed that the definition read: "It includes the franchisor or subfranchisor, and its employees, representatives, agents, and brokers, unless the franchisor or subfranchisor has, and is exercising, a right to approve or disapprove a franchisee's sale or transfer of its own outlet to another person and is not otherwise significantly involved in the sale or transfer." Lewis, Comment 15, at 8. We address transfers, however, in the definition of "franchise sale," as noted below. *See also* IL AG, Comment 3, at 3.

[167] J&G, Comment 32, at 9-10.

involved in a franchise sale, including franchisees,[168] trade show promoters, Web site owners, the mass media, or others who may be paid for referrals, but "who do not spend more than an hour with a prospective franchisee, or engage in substantive discussions with a prospective franchisee about the terms of a franchise agreement." J&G, Comment 32, at 10. On the other hand, John Baer questioned whether the Commission should ever distinguish between a franchisor and broker, asserting: "If any party offers to sell a franchise on behalf of a franchisor, that person should be considered a franchise seller." Baer, Comment 11, at 9.

Tricon voiced concern that the proposed definition would extend to all employees, even if they are not actively involved in franchise sales. The company would revise the definition to read: "It consists of the franchisor, the franchisor's third-party brokers, and those of the franchisors' employees, representatives, or agents who are involved in franchise sales activities." Tricon, Comment 34, at 3.

Frannet, a franchise referral company, urged the Commission to distinguish between franchise brokers and middlemen. The company agreed that anyone who sells franchises should be included in the definition of a franchise seller.[169] However, it insisted that the phrase "arranges for the sale" is undefined and goes beyond the commonly accepted definition of a broker. According to Frannet, middlemen or finders who just arrange for prospects to meet franchisors – but do not negotiate price or terms for the franchisor, or sign franchise agreements on behalf of a franchisor – should not be deemed brokers.

Frannet also voiced concern that the Commission's broad concept of a "broker" will have a direct impact upon a franchisor's Item 2 disclosures. As proposed in the NPR, Item 2 would require franchisors to disclose all brokers, and include their prior employment history. If so, the Commission's approach:

> would force a franchisor who has a referral agreement with an organization such as Frannet and each of its 57 Associates or with Tom Miller Associates who has agreements with literally hundreds of business brokers each of whom will receive a commission in the event that a prospect referred by any such person ultimately purchases a franchise, to disclose information about each of the hundreds of such

---

[168] *See also* Lewis, Comment 15, at 8 ("broker" definition should not "include a franchisee merely because the franchisee receives a payment from the franchisor or subfranchisor in consideration of the referral or a prospective franchisee to the franchisor or subfranchisor, if the franchisee does not otherwise participate in the sale of the franchise to the prospective franchisee. A franchisee does not participate in the sale of a franchise merely by participating in initial conversations or communications with a prospective franchisee about a franchise.").

[169] Frannet, Comment 2, at 1.

people and provide in the UFOC the information necessitated by Item 2. This is cumbersome, could cause the UFOC to be voluminous, and more importantly, be of no value to the prospective franchisee.

Frannet, Comment 2, at 2.[170] In short, Frannet asserted that only those individuals who have the authority to negotiate prices and terms on behalf of the franchisor should be deemed to be a broker under the Rule.

Finally, Howard Bundy raised another issue: the exemption for existing franchisees. According to Mr. Bundy, a franchisor may seek to evade disclosure requirements by having franchisees pose as "agents" who repeatedly establish and sell their own outlets. He would limit the exemption to "franchisees, who are not otherwise franchise sellers or affiliated with or under any other contractual relationship with the franchisor who sell their complete interest in all of their own outlets." Bundy, Comment 18, at 3.

As expressed in the NPR, the staff believes the term "franchise seller" is necessary as short-hand for referring, where appropriate, to all persons having obligations under the Rule. We agree, however, that the Commission should extend the list of franchise sellers to include subfranchisors. This is consistent with current Commission policy[171] and the UFOC Guidelines.[172]

We reject, however, the view that the Commission should distinguish between brokers and middlemen or finders. When promulgating the Rule, the Commission defined the term "broker" broadly to mean "any person other than a franchisor or a franchisee who sells, offers for sale, or arranges for the sale of a franchise." 16 C.F.R. § 436.2(j). Similarly, in the Statement of Basis and Purpose accompanying the Rule, the Commission clarified that a broker acts on behalf of a franchisor and receives compensation for arranging a franchise sale.[173] The term "broker,"

---

[170] We agree with Frannet that the Item 2 brokers disclosure is unnecessary. For a more detailed discussion of this issue, see section VI.D.2.b. below.

[171] In the Final Interpretive Guides, the Commission stated that franchisors and their subfranchisors who also sell franchises are jointly and severally liable for each other's disclosure obligations. 44 Fed. Reg. at 49,969.

[172] The UFOC Guidelines provide that "[i]n offerings by a subfranchisor, 'franchisor' means both the franchisor and subfranchisor." UFOC Guidelines, General Instructions 240.

[173] SBP, 43 Fed. Reg. at 59,717 & nn. 176 and 178. In staff advisory opinions we have interpreted the term "arranges" to include, for example, discussions with prospective franchisees about their specific business interests, pre-screening prospects through interest questionnaires, recommending specific franchise options, and assisting prospects in completing a franchisor's application form. Our view was based upon the SBP, in which the Commission took the position

therefore, is not limited to those persons who negotiate contract terms or sign franchise agreements and accept payments on behalf of a franchisor.[174] We agree.

Nonetheless, because the term "broker" does not appear in the Rule outside the definition of "franchise seller," we believe a separate Rule definition of "broker" within the Rule is unnecessary. Rather, we recommend explaining the concept of brokers more fully in the Compliance Guides. Specifically, we recommend that the Commission explain that a broker is a person who: (1) is under contract with the franchisor; (2) receives compensation from the franchisor; and (3) arranges franchise sales by assisting prospective franchisees in the sales process.[175]

Finally, we find some merit in Mr. Bundy's concern about the existing franchisee exemption. The exemption is intended to apply in those situations where an existing franchisee transfers ownership in his or her unit to another party without any continuing obligation to the purchaser. If, as Mr. Bundy suggested, an existing franchisee is engaged in repeated franchise sales, however, then that individual would be covered by the Rule either as the franchisor's agent, broker, or subfranchisor. Nonetheless, to clarify this point, we recommend that the Commission narrow the existing franchisee exemption to those existing franchisees who are not otherwise engaged in franchise sales on behalf of the franchisor.

Accordingly, we recommend that the Commission revise the NPR's proposed definition of "franchise seller" to read:

---

that group discussions about franchising and pre-screening of prospects may constitute a first personal meeting that would require a franchisor or broker to furnish disclosure documents. *See* Informal Staff Advisories 99-6 and 99-7, Bus. Franchise Guide (CCH), ¶¶ 6503-04 (1999).

[174] We note that the Commission has entered into consent agreements with several trade show promoters to resolve allegations that they, as brokers, were jointly and severally liable with the franchisor-exhibitors for making financial performance claims on trade show floors without providing the required earnings claim disclosures. *See FTC v. Entrepreneur Media, Inc.,* Bus. Franchise Guide (CCH), ¶ 10,583 (C.D. Cal. 1994); *FTC v. Shulman Promotions,* Bus. Franchise Guide (CCH), ¶ 10,584 (S.D. Ohio 1994). Pursuant to Commission policy, however, trade show promoters are conditionally exempt from the Rule as brokers, if they furnish show attendees with specific consumer education notices. *See* 46 Fed. Reg. 52,327 (Oct. 27, 1981).

[175] This proposal is sufficiently narrow to exclude existing franchisees who may refer potential franchisees to the franchisor because they are not under contract with the franchisor to sell franchises. In most instances, it would also exclude trade show promoters and the media who, typically, are not under contract with the franchisor, do not receive compensation from the franchisor for franchise selling, and who do not pre-screen or otherwise assist prospects in identifying specific franchise systems, or otherwise advance the franchise sale.

Franchise seller means a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor, and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. It does not include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.

H. Proposed Section 436.1(j): Franchisee

1. Background

The current Rule defines "franchisee" as: "any person (1) who participates in a franchise relationship as a franchisee, . . . or (2) to whom an interest in a franchise is sold." 16 C.F.R. § 436.2(d). In the NPR, the Commission proposed streamlining the definition to read simply: "*Franchisee* means any person who is granted an interest in a franchise." 64 Fed. Reg. at 57,298.

2. The record and recommendations

In response to the NPR, a few commenters voiced concern that the phrase "granted an interest in a franchise" is too broad. According to H&H, for example, the word "an interest in a franchise" is unnecessarily confusing, and it could be interpreted to encompass shareholders and other investors. H&H suggested that "franchisee" be defined simply as "any person who is granted a franchise."[176] H&H, Comment 9, at 25. BI also urged the Commission to clarify that: "there is no requirement that a disclosure document be furnished between affiliated companies. Because such transactions typically involve affiliated companies that are controlled by the same individuals or entities, the need to provide disclosures is not necessary for the protection of the affiliated company being granted the franchise." BI, Comment 28, at 2.

We agree that the proposed definition of "franchisee" should be revised. The phrase "interest in a franchise" is unnecessary and may have unintended consequences, as H&H suggested. A revised definition focusing on the grant of a franchise (as opposed to an interest in a franchise) is also consistent with the states' approach.[177] Accordingly, we recommend that the Commission adopt the following definition of franchisee: "*Franchisee* means any person who is granted a franchise." Finally, we find some merit in the argument that a franchisor's affiliates should not necessarily be considered franchisees. We address this issue below in our discussion of the Rule's exemptions.[178]

---

[176] *See also* BI, Comment 28, at 2.

[177] *See, e.g.,* Mich. Comp. Laws, § 445.1502(4); Wis. Stat. Ann. § 553.03(5).

[178] *See* proposed officers and owners exemption discussed at section IX.B.3.e below.

I. Proposed Section 436.1(k): Franchisor

1. Background

The current Rule defines "franchisor" as: "any person who participates in a franchise relationship as a franchisor, as denoted in paragraph (a) of this subsection." 16 C.F.R. § 436.2 (c). In the NPR, the Commission sought to streamline the current definition to mean "any person who grants an interest in a franchise and participates in the franchise relationship." 64 Fed. Reg. 57,332.

2. The record and recommendations

The proposed "franchisor" definition generated three comments. First, BI stated that the language "grants an interest" is too broad, arguably including a franchisee who sells an ownership interest in her own business. The firm would adopt the language used in several state franchise statutes, namely "grants a franchise," or "grants or offers to grant a franchise."[179]

Second, Warren Lewis suggested that the definition address "subfranchisors," noting comparable language in the Illinois and California Franchise Acts. He would add to the proposed definition: "It includes a subfranchisor unless otherwise stated." Lewis, Comment 15, at 11.

Finally, NASAA urged the Commission to expand the definition to include shareholders of privately-held corporations.[180] Although NASAA did not elaborate, its suggestion is apparently designed to make it easier to hold principals of closely-held corporations liable for Rule violations.

As explained in our discussion above concerning the "franchisee" definition, we agree that the term "interest in a franchise" is overly broad and unnecessary. Instead, the phrase "grants a franchise" would make the definition consistent with state law.[181] At the same time, it is important to make clear that a franchisor not only grants a franchise, but also participates in the franchise relationship.

As discussed below, there are two primary disclosure obligations under the Rule: (1) to make disclosures; and (2) to furnish disclosure documents. While the granting of a franchise is sufficient to trigger the obligation to furnish disclosure documents, it should be insufficient to compel the making of disclosures. For example, a third-party broker may grant a franchise on behalf of a franchisor, but otherwise have no obligation to perform under the franchise

---

[179] BI, Comment 28, at 2.

[180] NASAA, Comment 17, at 3.

[181] *E.g.,* Mich. Comp. Laws. § 445.1502(5); Wash. Rev. Code § 19.100.010(8).

agreement. Under the circumstances, the granting of a franchise alone should be insufficient to compel the third-party broker to disclose information about him or herself, such as prior litigation or a bankruptcy. On the other hand, a purported broker may not only sell franchises, but perform on behalf of a franchisor as well (such as providing promised training). In such instances, the broker is essentially a subfranchisor and should be covered by the Rule's obligation to make disclosures. To indicate that the term "franchisor" applies to a person who has both the obligation to furnish disclosures and to make disclosures, the definition of "franchisor" must reference both the granting of a franchise and participation in the franchise relationship.[182]

In the same vein, we agree with Warren Lewis that the definition of "franchisor" should be clarified expressly to include "subfranchisors." This is similar to the UFOC Guidelines approach, as noted above. The term "subfranchisor" as used in the Rule, therefore, means a person who functions as a franchisor, meaning a person who both engages in pre-sale activities and who has post-sale performance obligations. Accordingly, we recommend that the Commission revise the NPR's definition of "franchisor" to mean: "any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors."

We reject, however, NASAA's suggestion that the term "franchisor" include shareholders of privately-held entities. We believe it is inappropriate to hold persons individually liable under the Rule without satisfying the Section 5 liability standard.[183] In our experience, owners and officers of privately-held corporations, partnerships, and other entities are often indistinguishable from the corporate entity itself, making policy, and directing the franchise operations. In such circumstances, Section 5 of the FTC Act is sufficient to enable the Commission to hold such individuals liable for a corporation's Rule violations if the principals involved control or direct the corporation and have knowledge of the acts that constitute the corporation's misconduct.[184] Accordingly, further extension of the "franchisor" definition is unnecessary.

---

[182] *See* UFOC, General Instruction 230 (information about the subfranchisor should be disclosed, where applicable, the same as for the franchisor).

[183] Pursuant to Section 18(d)(3) of the FTC Act, 15 U.S.C. § 57a(d)(3), and 16 C.F.R. § 436.1, violations of the Franchise Rule constitute unfair or deceptive acts or practices in or affecting commerce, in violation of Section 5(a) of the FTC Act, 15 U.S.C. § 45(a). *See also* discussion of liability below at section V.E.

[184] *E.g., FTC v. Morrone's Water Ice, Inc.,* No. 92-3720 (E.D. Pa. 2002) (naming Stephen D. Aleardi and John J. Morrone, III, individually and as officers of corporate defendants); *FTC v. Car Wash Guys Int'l, Inc.*, No. 00-8197 ABC (RNBx) (C.D. Cal. 2000) (naming Lance Winslow, III, individually and as an officer of the corporate defendants).

J. Proposed Section 436.1(l): Leased Departments

1. Background

One of the current Rule's exemptions pertains to leased department arrangements. A leased department is created when a retailer rents space from a larger retailer in order to conduct business. For example, a jeweler may rent space from a department store to sell jewelry and watches. Technically, this relationship may be a franchise because the jeweler becomes associated with the department store's trademark, and the department store may impose conduct standards on the jeweler, such as operating hours. The Rule currently defines such arrangements as follows:

> Where 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).[185]

In the NPR, the Commission proposed retaining, but streamlining, the leased department exemption as follows:

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

64 Fed. Reg. 57,332.

2. The record and recommendations

Only one commenter, J&G, raised any concern about the proposed revised leased department definition. First, the firm asserted that the Commission has expanded the definition of leased department by eliminating the portion of the current definition covering the source of the lessee's goods.[186] Presumably, under the NPR proposal, a leased department would now be

---

[185] In the SBP, the Commission determined that these types of relationships need not be protected by the Rule because the retailer-lessee typically is experienced and can assess the value of the location and because the retailer-lessee's financial liability to the retailer-grantor is limited to rent. SBP, 43 Fed. Reg. at 59,708.

[186] J&G, Comment 32, Attachment, at 6, 13.

exempt from the Rule even if the retailer-grantor required the retailer-lessee to purchase goods from, for example, a specific third-party supplier. Second, the firm urged the Commission to expand the definition of leased department to include "co-branding" arrangements[187] where a department is licensed or leased to the same person who owns the interest in the real property from which another business will continue to operate. *Id.*[188]

The staff recommends that the Commission revise the proposed definition of "leased department" further to avoid any misinterpretation about its scope. We believe that the Commission did not intend to broaden the "leased department" exemption, as J&G suggested. Rather, the proposed definition was an attempt to streamline the current Rule's lengthy and unnecessarily confusing definition. To avoid any misinterpretation of the exemption's scope, we propose retaining the original Rule definition with some minor editing:

> *Leased department* means an arrangement whereby a retailer licenses or otherwise permits a seller to conduct business from the retailer's location where the seller purchases no goods, services, or commodities directly or indirectly from: (1) the retailer; (2) a person the retailer requires the seller to do business with; or (3) a retailer-affiliate if the retailer advises the seller to do business with the affiliate.

We reject, however, any suggestion that the definition of "leased department" be broadened to address co-branding. The issue of Rule compliance in co-branded arrangements was addressed in the ANPR[189] and at the New York public workshop conference on September

---

[187] Co-branding, a relatively new marketing development in franchising, enables a franchisee to use the trademarks and sell the goods or services of more than one franchise system. For example, an outlet that sells Taco Bell foods might also sell Pizza Hut pizza, or a gasoline franchise, such as Shell, may operate an on-site Subway Shop or 7-Eleven store.

[188] Similarly, H&H suggested that the Commission address co-branding in the Rule's instructions for the preparation of disclosures by subfranchisors:

> We believe that the Proposed Rule should state that, in the context of subfranchising and co-branding, required information should be included about the franchisor and subfranchisor, and the anchor franchisor and host franchisor, respectively, to the extent applicable. This will provide the necessary flexibility to prepare disclosure documents that are relevant to the particular structure, while providing prospective franchisees with all material information.

H&H, Comment 9, at 6.

[189] In the ANPR, the Commission stated that it was uncertain whether the purchaser of a co-branded franchise acquires two individually-trademarked franchises (and thus should receive separate disclosures from each franchisor) or acquires a hybrid franchise arrangement that has its

18, 1997. The commenters generally agreed that the Commission need not address co-branding, and none suggested any exemption from disclosure for co-branded franchises. Similarly, the New York workshop participants generally agreed that the current Rule is sufficient to address co-branding arrangements.[190] Neither franchisee advocates nor state regulators voiced any concerns to the contrary.[191] For that reason, the NPR contained no provisions directed at co-branding. We continue to believe that no compelling reason exists to address co-branding in the Rule. Even if we were to consider addressing co-branding, the record is insufficient for us to make any recommendation on how to address the issue through a rulemaking, and J&G has offered no detailed proposal for the Commission's consideration.

K. Proposed Section 436.1(m): Parent

Several commenters noted that the NPR did not define the term "parent."[192] A few commenters suggested that because several Rule provisions address parent disclosures, the Commission should expressly define that term.[193] For example, Warren Lewis recommended that the Commission adopt the following definition: "Parent means an entity that directly or indirectly has an 80% or greater ownership interest in the franchisor." Lewis, Comment 15, at 9.

We recommend that the Commission adopt the definition of parent set forth in the Final Interpretive Guides: "an entity that controls the franchisor directly, or indirectly through one or

---

own risks and, thus, should receive a single unified document that discloses information specific to the co-branding arrangement. The ANPR asked whether franchisors have sufficient guidance under the Rule to determine their disclosure obligations with respect to the sale of co-branded franchises and whether new or different disclosures should apply to the sale of co-branded franchises. 62 Fed. Reg. at 9,122. Ten ANPR commenters addressed co-branding. Quizno's, ANPR 16, at 2; Baer, ANPR 25, at 7; H&H, ANPR 28, at 9; Kaufmann, ANPR 33, at 16; Kestenbaum, ANPR 40, at 2-3; IL AG, ANPR 77, at 4-5; IFA, ANPR 82, at 4; Kirsch, ANPR 98; Jeffers, ANPR 116, at 9; WA Securities, ANPR 117, at 4. With the exception of Quizno's, the ANPR commenters maintained that the Commission's current pre-sale disclosure approach is sufficient to address co-branded franchise arrangements. *See* Quizno's, ANPR 16, at 2 (sufficient guidance does not exist with respect to co-branding arrangements).

[190] *E.g.,* Kirsch, ANPR, 18Sept97 Tr, at 176; Wieczorek, *id.,* at 177-78; Kestenbaum, *id.*, at 178-79; Simon, *id.*, at 179.

[191] Dale Cantone, of Maryland Securities, stated: "We haven't had too many problems on the issue of co-branding. We've had franchisors file disclosures and we really haven't had too many issues with it." Cantone, ANPR, 18Sept97 Tr, at 182.

[192] *E.g.,* PMR&W, Comment 4, at 9; H&H, Comment 9, at 12.

[193] *E.g.,* Baer, Comment 11, at 10-11.

more subsidiaries." 44 Fed. Reg. at 49,972. We believe that the essence of the parent-subsidiary relationship is one of control.[194] In that regard, we note that Mr. Lewis does not state the basis for his recommendation that the Commission adopt an 80% ownership interest test. One possibility is that he borrowed from the following language in UFOC Item 21: "a company controlling 80% or more of a franchisor may be required to include its financial statements." Item 21, however, does not specifically purport to define the term "parent." Rather, it merely suggests that a large controlling interest may give rise to financial disclosure obligations. Indeed, in promulgating the Rule, the Commission did not adopt any specific level of control test. To the contrary, the Commission defined parent "broadly," as noted above. We believe that is the proper approach.

L. Proposed Section 436.1(n): Person

1. Background

In the NPR, the Commission proposed retaining the current Rule's definition of "person" as follows: "*person* means any individual, group, association, limited or general partnership, corporation, or any other business entity." 64 Fed. Reg. at 57,332.[195]

2. The record and recommendations

In response to the NPR, Warren Lewis suggested that the Commission change "other business entity" to simply "other entity" and add the following: "An individual is not an entity." Lewis, Comment 15, at 10. Mr. Lewis maintained that these changes will make it clear throughout the Rule that "person" means an individual or business entity; while entity means only a business entity. *Id*. J&G also suggested that the definition of person include limited liability companies.[196]

Based upon the comments, we propose that the Commission revise the definition of "person" in part. "Person" is a term of art used in many Commission rules to refer to a party, regardless of whether the party is an individual, organization, or business entity. Where necessary, the Commission can distinguish between parties by using more specific terms – individual, organization, or entity. We believe that these more specific terms are clear, and, therefore, we need not distinguish between individuals and entities, as suggested. Nonetheless, we agree with Mr. Lewis that, in context, the word "business" attached to "entity" in the proposed definition is unnecessary. On the other hand, we find that the term "entity" is sufficient

---

[194] This is similar to the proposed "affiliate" definition. *See* proposed section 436.1(b) above.

[195] *See also* 16 C.F.R. § 436.2(b).

[196] J&G, Comment 32, Attachment, at 14.

to cover limited liability companies or similar business arrangements. Accordingly, we recommend that the Commission revise the definition of "person" to mean: "any individual, group, association, limited or general partnership, corporation, or any other entity."

M. Proposed Section 436.1(p): Predecessor

1. Background

Several of the proposed Rule disclosures pertain to the franchisor's predecessor, such as Item 3 litigation and Item 4 bankruptcies. The current Rule does not require the disclosure of predecessor information, and therefore, does not define that term. Item 1 of the UFOC Guidelines, however, defines predecessor as "a person from whom the franchisor acquired directly or indirectly the major portion of the franchisor's assets." UFOC Guidelines, Item 1 Instructions, iii.[197] In the NPR, the Commission proposed a broad definition of "predecessor" that would expand the UFOC Guidelines' definition, as follows:

> *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

64 Fed. Reg. 57,332.

2. The record and recommendations

Eleven commenters opposed the NPR's proposed "predecessor" definition. They asserted that the definition's references to the company from whom the trademark was acquired is too broad,[198] and would result in burdensome disclosures that are immaterial to prospective franchisees.[199] The NFC, for instance, noted that many large corporations, especially those with a foreign presence, use a series of corporations to "funnel their marks to the franchisor." NFC, Comment 12, at 3-4. This is done for tax purposes and foreign ownership requirements. According to the NFC, these corporations are often dormant, and are "never involved with the solicitation of franchisees, the sale of franchises, or administration of the franchise network." *Id.*

Similarly, Marriott questioned the relevance of information about the original licensor from whom the franchisor obtained the use of the trademark:

---

[197] *See also* NASAA Commentary, Bus. Franchise Guide (CCH), ¶ 5790, at 8,465 ("The definition of predecessor in instruction iii to Item 1 should be applied throughout the UFOC.").

[198] *E.g.,* H&H, Comment 9, at 15; BI, Comment 28, at 2.

[199] *E.g.,* PMR&W, Comment 4, at 8; Baer, Comment 11, at 11; Snap-On, Comment 16, at 2.

> The Proposal would require disclosures in Item 1, 3 and 4 about entities which license any trademarks or trade secrets used in the "franchise operation." The term is not limited to principal trademarks, but even if it were so limited, it is not clear why, for example, disclosure of such information about the late Roy Rogers or King Features Syndicate, the licensor of "Popeye's" trademark, is relevant or desirable to the prospective purchasers of a Roy Rogers or Popeye's franchises.

Marriott, Comment 35, at 13-14.[200]

Finally, commenters asserted that it would be burdensome to obtain background information from original licensors: "Obtaining accurate and complete information on this new proposed class of predecessors, licensors, would be . . . difficult, but would not result in the disclosure of significant new information to prospective franchisees." Lewis, Comment 15, at 10.[201]

The staff believes that information about predecessors is essential in order to avoid fraudulent franchise sales. Our law enforcement experience demonstrates that, in some instances, franchisors reincorporate under a new name as a simple way to avoid disclosing damaging information, such as prior litigation or a bankruptcy.[202] Nonetheless, we agree with the NPR commenters that the reference to original license holder is broader than necessary to prevent fraud and would require franchisors to obtain information from companies over which they have no control. Moreover, this information may be immaterial to a prospective franchisee because the original trademark licensor may have no legal responsibilities to the prospective franchisee. Disclosures about original license holders could also be misleading, especially if the license holder is the franchisor's parent company: they could imply a greater degree of oversight of the franchisor, as well as the franchisor's prior experience and financial stability. For these reasons, the staff recommends that the Commission adopt the UFOC Guidelines' limited definition of predecessor, as noted above.[203]

---

[200] *See also, e.g.,* PMR&W, Comment 4, at 8; J&G, Comment 32, at 9. Commenters also observed that information about the franchisor's trademark is already disclosed in Items 12-13. *E.g.,* Baer, Comment 11, at 10; Lewis, Comment 15, at 10.

[201] *See also, e.g.,* AFC, Comment 30, at 2; Marriott, Comment 35, at 14.

[202] See discussion of Item 1 below at section VI.C.

[203] *See* n.197 above.

N. Proposed Section 436.1(r): Prospective Franchisee

1. Background

Under the current Rule, franchisors must furnish disclosure documents to prospective franchisees only. The Rule defines the term "prospective franchisee" as "any person, including any representative, agent, or employee of that person, who approaches or is approached by a franchisor or franchise broker, or any representative, agent, or employee thereof, for the purpose of discussing the establishment, or possible establishment, of a franchise relationship involving such a person." 16 C.F.R. § 436.2(e).[204] In the NPR, the Commission proposed adopting the current definition, with minor editing. Specifically, the phrase "franchisor or franchise broker" would be replaced with the inclusive term "franchise seller," as discussed above:

> 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.

64 Fed. Reg. at 57,332.

2. The record and recommendations

In response to the NPR, BI voiced concern about who may receive a disclosure document, and suggested revising the definition to provide that it is sufficient for any representative of the franchisee to receive the disclosures.[205] J&G also questioned the use of the word "approaches" in the definition. Specifically, the firm feared that the definition would include someone surfing the Internet who "approaches" a franchisor's Web site.[206]

The staff recommends that the Commission retain the definition of "prospective franchisee," as proposed in the NPR. We agree with BI that the Rule should permit a franchisee's representative to accept delivery of the disclosure document. We recognize that in some instances a prospective franchisee can be a corporation or other entity, not an individual. Thus, delivery in such circumstances can only be made upon a representative. Even an individual may wish to have his or her attorney or other agent receive the disclosures on their behalf, and the Rule should accommodate that possibility. We recommend, therefore, that the Compliance Guides make clear that a representative can accept disclosures on behalf of a prospective franchisee.

---

[204] The UFOC Guidelines do not specifically define the term "prospective franchisee."

[205] BI, Comment 28, at 3.

[206] J&G, Comment 32, at 7.

We believe J&G's concern that Internet surfers might be deemed prospective franchisees, however, is unwarranted. The proposed "prospective franchisee" definition states that the parties must "discuss the possible establishment of a franchise relationship." This limiting language makes clear that for an individual to become a "prospective franchisee" he or she must intend to engage in some dialogue about a franchise offering. Unilateral surfing of a franchisor's Web site hardly rises to the level of a "discussion." Therefore, merely perusing a franchisor's Web site alone does not turn an ordinary Internet surfer into a prospective franchisee.

O. Proposed Section 436.1(s): Required Payment

1. Background

Under the current Rule, the making of a "required payment" (or a commitment to make a "required payment") is one of the definitional elements of the term "franchise."[207] The Rule, however, currently does not define the term "required payment." In the NPR, the Commission proposed the following definition: "*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." 64 Fed. Reg. at 57,332. The proposed definition would incorporate the Commission's long-standing policy that a payment can be required by contract or by practical necessity.[208]

2. The record and recommendations

In response to the NPR, several commenters raised concerns about the scope of the "required payment" definition. Specifically, commenters voiced concern whether the definition: (1) covers royalty payments; (2) is limited to payments for the right to enter into the franchise relationship; (3) excludes payments for inventory; and (4) includes payments to third parties. We address each issue below.

a. Royalty payments

As noted above, the NPR defined the term "required payment" using the phrase "consideration that the franchisee must pay." 64 Fed. Reg. at 57,332. The IL AG interpreted the word "consideration" as excluding royalty payments. It urged the Commission to clarify that

---

[207] 16 C.F.R. § 436.2(a)(2).

[208] *See* Final Interpretive Guides, 44 Fed. Reg. at 49,967. The staff has provided the same advice in several informal advisory opinions. *E.g.,* Chrysler Corp., Bus. Franchise Guide (CCH) ¶ 6,383 (1979).

royalties can constitute a required fee. Otherwise, "it will be too simple, even for traditional franchisors, to evade franchise laws." IL AG, Comment 3, at 5.[209]

The Commission has always considered royalty payments to be a form of required payment under the Rule.[210] We believe this policy is sound because royalty payments are clearly a direct form of revenue flowing to the franchisor in exchange for the ability to conduct business. Indeed, if royalties were excluded from the required payment definition, then any franchisor could avoid Rule coverage by charging a large post-sale royalty fee in lieu of an initial franchise or related fee. The NPR used the term "consideration" not to imply that only an upfront franchise fee constituted a required payment under the Rule, but to avoid the circular use of the word "payment" in the definition of "required payment." Also, alternatives such as "funds, or moneys" are too limited because they would preclude payments in-kind. Accordingly, we recommend that the Commission clarify in the Compliance Guides that the term "consideration" includes post-sale payments such as royalties.

b. Obtaining or commencing operation

John Baer voiced concern that the definition would cover payments made "as a condition of obtaining or commencing operation of the franchise." Baer, Comment 11, at 8. He urged the Commission to clarify that a payment must be made "for the right to enter into the franchise relationship," asserting that courts have distinguished between a "fee paid for the right to do business" and "fees paid in the course of business." *Id*.

We decline to adopt this suggestion. In the Interpretive Guides, the Commission used two phrases to describe the required payment element. First, the Commission stated that: "The franchisee must be required to pay to the franchisor . . . *as a condition of obtaining or commencing the franchise operation*." Final Interpretive Guides, 44 Fed. Reg. at 49,967 (emphasis added). Later in the same section, the Commission stated that the term "required payment" captures "all sources of revenue which the franchisee must pay to the franchisor or its affiliate *for the right to associate with the franchisor* and market its goods or services." *Id.* (emphasis added). While both phrases are substantially similar, and arguably interchangeable, we believe the former describes the payment requirement more precisely.

The "right to associate" language could be misinterpreted as limiting the required payment element to payments made solely for the right to enter into the business, such as an up-

---

[209] *See also* J&G, Comment 32, Attachment, at 15 (questioning whether "consideration" excludes royalty payments).

[210] *See* Final Interpretive Guides, 44 Fed. Reg. at 49,967 ("Among the forms of required payments are . . . continuing royalties on sales."). If not, a franchisor could easily avoid Rule coverage by forgoing an up-front fee in favor of larger royalty payments during the course of the franchise agreement.

front franchise fees. However, the Commission has made clear that the required payment element is not limited to up-front fees alone: "Often, required payments are not limited to a simple franchise fee, but entail other payments which the franchisee is required to pay to the franchisor or an affiliate." *Id.* Accordingly, we believe that expenses made in the ordinary course of business to a franchisor or its affiliate may constitute a required payment, as demonstrated by the illustrative examples of required payments in the Final Interpretive Guides, which include equipment rentals and real estate leases. *Id*. If not, franchisors could easily circumvent the Rule by refraining from imposing any up-front fee in favor of charging for ordinary business expenses, such as training or other services, or purchases of equipment or unreasonable amounts of inventory.[211]

c. Payments for inventory

Two commenters addressed the issue of payments for inventory. Under the current Rule, reasonable amounts of inventory purchased at bona fide wholesale prices do not constitute a "required payment" as a matter of Commission policy.[212] This is commonly referred to as "the inventory exemption." David Gurnick urged the Commission to update the Rule by incorporating the inventory exemption into the definition of required payment itself.[213] John Baer agreed and would expand the exemption to include not only inventory for resale, but inventory for lease. Otherwise, the situation could arise where inventory obtained from a company is intended for resale – thus taking it outside of the Rule – but later on leased to a customer – thus creating a franchise relationship retroactively.[214]

Based upon the record, we recommend that the Commission revise the proposed definition of "required payment" to include the inventory exemption. As the Commission stated in the Final Interpretive Guides, it is "virtually impossible to draw a clear line between start-up inventory that is purchased at the franchisee's option, and that which is purchased as a matter of practical or contractual necessity." 44 Fed. Reg. at 49,967. Accordingly, since the late 1970s, the Commission has determined that reasonable purchases of inventory for resale at bona fide wholesale prices should not be construed as a "required payment." We believe this policy is

---

[211] *See* SBP, 43 Fed. Reg. at 59,703 and n. 51 (discussing problem of "indirect or disguised" franchise fees).

[212] *See* Final Interpretive Guides, 44 Fed. Reg. at 49,967. In the NPR, the Commission proposed incorporating the inventory exemption in the current minimum payment exemption. *See* 64 Fed. Reg. at 57,345. However, because the inventory exemption helps to define what constitutes a required payment, we recommend that it be included in the definition of "required payment."

[213] Gurnick, Comment 21A, at 10.

[214] Baer, Comment 11, at 8.

sound. As suggested, we further recommend that the Commission expand the inventory exemption to include inventory purchased for lease. We see no practical distinction between purchase for resale and purchase for lease, as urged above.

d. Payments to third parties

Finally, Howard Bundy urged the Commission to expand the concept of "required payment" to include payments made to third parties. According to Mr. Bundy, franchisors can effectively "hook" a prospective franchisee if they can get the prospect to expend funds early in the sales process, such as paying travel expenses:

> In franchising, it has become common to use the "takeaway close" to entice prospects to travel to the franchisor's headquarters as a condition precedent to receiving a disclosure document. Likewise, we see instances of franchisors requiring a franchisee to contract with or pay for demographic or real estate services with technically "unaffiliated" entities as a condition precedent to being "approved" as a franchisee.

Bundy, Comment 18, at 4. To address this concern, Mr. Bundy suggested that the Commission modify the proposed definition of "required payment" to include, after the word affiliate: "or to a vendor, financing provider or other third party that the prospective franchisee is required to deal with either by contract or practical necessity or to any third party as a condition precedent to obtaining the Franchise Disclosure Document." *Id.*

Mr. Bundy's suggested expansion of the "required payment" definition to include payments to third parties generated one rebuttal comment. Mr. Gurnick observed that defining required payment to include third-party payments would be: "a radical departure from the Commission's long-standing policy regarding the definition of a franchise, would create a major inconsistency between the Franchise Rule and the state franchise laws, and would extend coverage to arrangements which the Rule was never intended to regulate." Gurnick Rebuttal, Comment 36, at 2. Observing that all businesses make payments to vendors and service providers, he also asserted that the Bundy proposal would be overbroad: "For example, 'practical necessity' may dictate that a business use a Microsoft software product or that an employee of the business fly to an airport that is served by only one airline." *Id.* at 3. Mr. Gurnick added that if a franchisor establishes a company to receive some monetary benefit from prospects, those funds would already fall within the "required payment" definition as a payment to an affiliate. *Id.* at 3-4.[215]

---

[215] Mr. Gurnick also disputed the view that franchisors entice prospects to incur costs, such as airline tickets. "No data is [sic] provided to support this claim, and frankly I question whether companies really have an interest in enticing prospects to buy, for example, airline tickets." *Id.* at 4.

Mr. Gurnick correctly noted that the Commission has never considered ordinary business payments to third parties as a required payment under the Rule. Indeed, doing so would sweep all sorts of non-franchise relationships into the Rule. Ordinary business expenses paid to third parties, such as the cost of installing telephone lines, insurance, and occupancy fees – expenses typically incurred by all businesses – can hardly be deemed a precondition imposed *by the franchisor* for commencing or operating the franchise. Rather, a third-party payment would be deemed a required payment only if the third party collects and remits the payment on behalf of the franchisor.[216]

Nonetheless, we believe there is merit in Mr. Bundy's observation that a franchisor may direct or encourage a prospective franchisee to incur some costs in order to advance the franchise sale. These payments are often made by the prospective franchisee without the benefit of pre-sale disclosures. For example, a franchisor might encourage a prospect to fly across the country to visit its headquarters. If the prospective franchisee knew, for example, that the franchisor was involved in significant litigation with its franchisees, or was under a Commission order for fraud, he or she might decline the invitation. We also believe that encouraging a prospect to incur expenses to advance the franchise sale might "hook" or "pre-condition" the prospect, making it more likely that he or she will go through with the deal without a thorough due-diligence investigation.

Rather than recommending that the Commission modify the "required payment" definition to address this concern, we propose an alternative approach: an express prohibition barring a franchisor from failing to furnish a copy of its disclosure document to a prospective franchisee early in the sales process, upon reasonable request.[217] If this prohibition were adopted, then a prospective franchisee could ask to see a copy of the franchisor's disclosure document before agreeing to travel to company headquarters or purchase demographic data, for example. We believe this approach would effectively address the commenters' concern about pre-disclosure third-party payments without changing the Commission's long-held interpretation of the term "required payment."

P. Proposed Section 436.1(t): Sale of a Franchise

1. Background

The Franchise Rule's disclosure obligations are triggered only if there is a franchise sale. The current Rule defines the term "sale of a franchise" as:

> including a contract or agreement whereby a person obtains a franchise or interest in a franchise for value by purchase, license, or otherwise. This term shall not be

---

[216] *See* Final Interpretive Guides, 44 Fed. Reg. at 49,967.

[217] *See* section X.B.4. below.

> deemed to include the renewal or extension of an existing franchise where there is no interruption in the operation of the franchised business by the franchisee, unless the new contracts or agreements contain material changes from those in effect between the franchisor and franchisee prior thereto.

16 C.F.R. § 436.2(k). In the NPR, the Commission proposed retaining the current definition of "sale of a franchise," with some minor editing.[218]

2. The record and recommendations

In response to the NPR, one commenter, H&H, raised several concerns about the proposed definition's scope. First, the firm urged the Commission to exclude from the definition the modification of an existing franchise agreement where there is no interruption in the franchisee's business operation.[219] The firm observed that material modifications to existing franchise agreements typically arise in two situations: (1) a settlement of litigation or other disputes with franchisees, in which the franchisor makes concessions; and (2) management initiative with the involvement of independent franchisee associations or franchisee advisory councils.[220] According to H&H, these modifications typically entail no new investment and both sides are familiar with the franchise terms: "An offer to exchange different forms of agreement or add an addendum to existing franchise agreements does not establish a new franchise relationship – that relationship already exists and will continue regardless of the decision the franchisee makes." H&H, Comment 9, at 10.

H&H further contended that disclosure is unwarranted for renewals in all circumstances, asserting that a renewing franchisee makes no investment decision: "His decision relates to whether to continue a relationship, with which he should be intimately familiar at that point, under the terms of a new form of franchise agreement. The UFOC does little to help him understand the terms of that agreement." *Id.* at 11.

Finally, H&H maintained that the Commission's proposed definition of "sale of a franchise" may have unintentionally increased disclosure requirements in connection with transfers. Under the current Rule, if a franchisor's role in a transfer is limited to approving or disapproving of a transferee, then the franchisor need not provide the prospective transferee with a disclosure document. Yet, the NPR's proposed definition of "sale of a franchise" is drafted broadly, encompassing all transfers. Further, the definition of "franchise seller" exempts a franchisee who sells a franchise, but fails to address the franchisor's disclosure obligation during the transfer. "In other words, in any transfer of a franchise (regardless of the franchisor's role),

---

[218] *See* 64 Fed. Reg. at 57,332.

[219] H&H, Comment 9, at 9-10.

[220] *Id.* at 10.

the transferring franchisee has no obligation to provide the disclosure document, but the franchisor always does." *Id.* at 11. H&H suggested that the "sale of a franchise" definition should be modified so that it does not "encompass the transfer of a franchise by an existing franchisee where the prospective franchisee has no significant contact with the franchisor. Actions of the franchisor in approving or disapproving the purchaser should not be deemed to be significant contact." *Id.*

As an initial matter, we do not agree with H&H's suggestion that renewals should always be excluded from the definition of "sale of a franchise." As discussed in section VI.S. of this Report, franchisees and their representatives have voiced concern about renewals, arguing that franchisors control the governing terms and conditions and offer renewals on a take-it or leave-it basis. Franchisees, they have asserted, not only lack bargaining power over the renewal agreement, but also often must accept even onerous terms because they are frequently subject to covenants not to compete that effectively prevent them from continuing in the same business independently.[221] Especially in an age of new technologies and changes in franchise marketing, renewal contracts may be significantly different from original contracts that franchisees signed 10 to 20 years ago. A renewing franchisee, for example, may wish to see Item 20 closure rates for franchises operating under the new franchise agreement. Under such circumstances, we believe that the renewing franchisee should receive disclosures in order to make an informed renewal decision.[222]

On the other hand, we agree with H&H that the NPR's proposed "sale of franchise" definition could be read as compelling franchisors to furnish disclosures during private, voluntary transfers by existing franchisees in all instances. Under current Commission policy, a franchisor or subfranchisor must provide disclosures to prospective franchisees only. "[A] person who purchases a franchise directly from an existing franchisee, without significant contact with the franchisor, is not a prospective franchisee." Final Interpretive Guides, 44 Fed. Reg. at 49,969. Where an existing franchisee sells his or her own outlet with no continuing obligation to the purchaser, the franchisee does not function as a franchisor because it has no continuing contractual obligations to the purchaser. In such circumstances, the purchaser is not relying on any sales representations of the franchisor, but on the terms and conditions spelled out in the existing contract. If there is any fraud in the sale, it would be by the existing franchisee, and pre-sale disclosure by the franchisor is not likely to prevent it.

In contrast, a franchisor who actively participates in a franchise transfer should be obligated to make disclosures to a potential transferee, no less than to a prospective franchisee.

---

[221] *See* NPR, 64 Fed. Reg. at 57,308-09.

[222] This assumes, of course, that there is a "sale," meaning the existing franchisee makes a *required payment* for the right to enter into a *new* franchise agreement. Entering into a new franchise agreement without any required payment or extending an existing franchise agreement for a fee would not be deemed a "sale of a franchise" for Rule purposes.

In such events, the prospective transferee may rely on the franchisor's representations in deciding to purchase the franchise, and therefore, should receive the benefit of pre-sale disclosure. To that end, we recommend that the Commission exclude transfers from the definition of "sale of a franchise" where the franchisor has had no significant involvement.

At the same time, we recognize that an argument can be made that all prospective transferees should be entitled to the benefits of pre-sale disclosure in order to make an informed investment opportunity. However, we would not go that far. For example, a franchisor may have stopped selling franchises when an existing franchisee decides to sell his or her unit. If so, it would be unreasonable to compel a franchisor to incur the costs of creating a disclosure document solely to assist an existing franchisee in selling his or her unit. Rather, we believe that a better approach would be to create a new prohibition barring franchisors from failing to furnish a prospective transferee with a copy of an existing disclosure document upon reasonable request.

Finally, we agree in theory that disclosure may be unwarranted where an existing franchisee and the franchisor merely seek to amend their ongoing contractual relationship. In such circumstances, the material information the franchisee needs is the actual revised franchise agreement itself that spells out the terms and conditions that will govern the parties' ongoing relationship. Under the UFOC Guidelines approach – and by extension, the proposed revised Rule approach – the disclosure document merely summarizes the relevant contractual provisions with references to the sections of the contract that govern a party's obligations. We believe that requiring franchisors to furnish a new disclosure document whenever there may exist agreed upon material changes in a contract is likely to be an unwarranted formality that is probably not outweighed by any tangible benefit to the existing franchisee. Nevertheless, we do not consider franchise agreement modifications, especially those without any new payment, to constitute a "sale." The definition of "sale of a franchise," therefore, need not be revised to address this concern.[223]

For the reasons stated above, we recommend that the Commission modify the NPR's proposed definition of "sale of a franchise" as follows:

> *Sale of a franchise* includes an agreement whereby a person obtains a franchise from a franchise seller for value by purchase, license, or otherwise. It does not include extending or renewing an existing franchise agreement where there has been 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. It also does not include the transfer of a franchise by an existing franchisee where the franchisor has had no significant involvement with the prospective transferee. A franchisor's approval or disapproval of a transfer alone is not deemed to be significant involvement.

---

[223] If further explanation is desirable, we can address this issue more fully in the Compliance Guides.

Q. Proposed Section 436.1(u): Signature

1. Background

To facilitate the use of electronic signatures, the NPR proposed a flexible definition of "signature" that would include security codes, passwords, and digital signatures: "*Signature* means a person's affirmative steps to authenticate his or her identity. It includes a person's use of security codes, passwords, digital signatures, and similar devices." 64 Fed. Reg. at 57,333.

2. The record and recommendations

No comments were submitted in response to the NPR proposal. Nonetheless, we recommend minor revisions to the proposed "signature" definition. Specifically, we propose including a reference to the standard handwritten signature, which was inadvertently excluded, as well as broadening the definition by substituting the word "electronic" for "digital."

R. Deleted Definitions

1. Background

In the NPR, the Commission also proposed to define three additional terms: "Internet," "material," and "officer." For the following reasons, we recommend that the Commission delete these three definitions from the final revised Rule.

2. The record and recommendations

a. Proposed "Internet" definition

The NPR proposed to update the Rule's definitions by adding a broad definition of the term "Internet" to capture all computer-to-computer communications, including telephones and facsimiles:

> *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.

64 Fed. Reg. at 57, 332.[224]

John Baer found it "strange" that the definition of "Internet" includes communications between computers and telephones and facsimiles. He would prefer to use the term "computer

---

[224] *See also* 64 Fed. Reg. at 57,298.

communications." Baer, Comment 11, at 9. Howard Bundy also saw several problems with the proposed definition of "Internet." He urged the Commission to keep in mind that "with evolving technologies and our propensity for re-naming things where there is even a slight change, the term 'Internet' may become as obsolete within five years as the term 'floppy disk.'" Bundy, Comment 18, at 3-4. Further, he argued that the proposed definition may not encompass personal communications devices such as Palm Pilots or "Internet ready cellular telephones." Rather than use the term "Internet," he would use "electronic communication." *Id*.

Upon further consideration, the staff believes that a specific definition of the term "Internet" is unwarranted. First, the term "Internet" is commonly understood today. Second, we agree that it would be counterproductive to attempt to define the term (or an alternative such as "electronic communication"), when communications technology is evolving so rapidly. Accordingly, we propose to delete the proposed "Internet" definition from the final revised Rule. If any additional clarification is necessary, we can address it in the Compliance Guides.

b. Proposed "material" definition

The current Rule defines "material, material fact, and material change" as 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.

16 C.F.R. § 436.2(n).[225]

In the NPR, the Commission proposed to streamline, but not substantively change, the current definition as follows:

> *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.

64 Fed. Reg. at 57,332.

In response to the NPR, no commenters raised any concerns about the proposed revised definition. Nonetheless, the staff recommends that the Commission delete the definition of "material" due to the following policy concerns. First, the current and proposed Rule use the

---

[225] The UFOC Guidelines do not specifically define "material." Rather, in discussing the term "action," the Guidelines state "Included in the definition of material is an action or an aggregate of actions if a reasonable prospective franchisee would consider it important in making a decision about the franchised business." UFOC Guidelines, Item 3 Definitions, iii.

term material in at least two different ways. "Material" means influencing the purchaser's decisionmaking process, such as the proposed Item 3 disclosure of "material litigation." At other times, the Rule uses "material" to mean "significant" or "important" generally. For example, franchisors would disclose in Item 8 whether the franchisor provides material benefits to a franchisee based on a franchisee's purchase of particular products or services. Given the different uses of the term "material," we believe the single, proposed definition would be inaccurate. More important, the term "material" is already defined by Commission case law and may evolve. We believe it is important that the Commission maintain a consistent interpretation and application of "material" over time in all realms and not carve out specific definitions for individual Rules or orders.

c. Proposed "officer" definition

The current Rule does not specifically define the term "officer." Rather, in the prior business experience disclosure the Rule provides that an officer includes "the chief executive and chief operating officer, financial, franchise marketing, training, and service officers." 16 C.F.R. § 436.1(a)(2).[226] In the NPR, the Commission proposed adding a new definition – "officer," explicitly defining the term as follows:

> *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.

64 Fed. Reg. at 57,332. The Commission explained that this definition 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." *Id.* at 57,299.[227]

---

[226] The UFOC Guidelines are similar: "Principal officers include the chief executive and chief operating officer, the present, financial, franchise marketing, training and franchise operations officers." UFOC Guidelines, Item 2 Instructions, i. *See also* NASAA Commentary, Bus. Franchise Guide (CCH) ¶ 5,800, at 8,466 (Item 4 bankruptcy disclosures).

[227] During the Chicago public workshop conference, a former franchisee, Charles Lay, told us that his franchisor did not disclose pre-sale that the franchisor's director of franchising (who was not a titled corporate officer) had been discharged in bankruptcy. Mr. Lay stated that, because the franchisor was small, operated by only five or six people, such a disclosure was "critical, even though this person was not formally an officer." Lay, ANPR, 22Aug97 Tr, at 6. *See also, e.g., FTC v. P.M.C.S., Inc.*, No. 96-5426 (E.D.N.Y. 1996) (franchisor failed to disclose "silent partner" with prior bankruptcy); *FTC. v. Why USA, Inc.,* No. 92-1227-PHX-SMM (D.

In response to the NPR, NASAA strongly supported the inclusion of *de facto* officers in the proposed "officer" definition, asserting it is necessary for effective law enforcement:

> The law enforcement experience of some members of the Franchise Project Group reflects that franchisors and sellers of business opportunities have attempted to avoid litigation disclosures under the FTC Franchise Rule or comparable state disclosure laws by purposely not giving the title "officer" to individuals who, in fact, exercise significant management responsibility over a business.

NASAA, Comment 17, at 3.

Other commenters agreed that the Rule should require the disclosure of information about those with management responsibilities, but opposed the term "*de facto* officer." In their view, the term "*de facto* officer" is "nebulous,"[228] would create more problems than it would solve,[229] and would unnecessarily expand the business background, litigation, and bankruptcy disclosures required by Items 2-4.[230]

PMR&W asserted that a corporate title almost always is a meaningful indicator of a person's responsibilities and authority. The firm urged the Commission to adopt the UFOC Guidelines approach by focusing on Item 2, adding after "parent" in the second line "and any other person." PMR&W, Comment 4, at 8.[231] So revised, Item 2 would read, in relevant part:

> Disclose the position and name of the directors, trustees, general partners, officers, and subfranchisors of the franchisor or any parent and any other person who will have management responsibility relating to the offered franchises . . . .

The NFC opposed the term "*de facto* officer" on other grounds. The association noted that many states have statutes that impose certain duties, responsibilities, and liabilities upon officers. It feared that the proposed definition would "upset traditional notions of what an officer is under state and federal law." NFC, Comment 12, at 2-3.

In a similar vein, David Gurnick stated that the term "*de facto* officer" is a vague standard that would open the door to future litigation. The term arguably could apply to wives, spouses,

---

Ariz 1992) (alleging that franchisor failed to disclose officers and their prior litigation).

[228] Snap-On, Comment 16, at 2.

[229] J&G, Comment 32, at 8; Marriott, Comment 35, at 12.

[230] J&G, Comment 32, at 8.

[231] *See also* Baer, Comment 11, at 9; Marriott, Comment 35, at 12.

and others who never agreed to serve as officers of a franchisor. He suggested that:

> The persons whose backgrounds need to be disclosed are anyone with management authority for the franchise program, whether or not they are officers. The FTC can accomplish this goal by requiring disclosure of anyone with management authority; but not broadening the disclosure to create a new concept of de facto officer.

Gurnick, Comment 21, at 3-4. Tricon also voiced concern that there may be many directors or managers in large organizations, each of whom would now have to be disclosed. This would lengthen the disclosures and require more frequent updating.[232] Howard Bundy offered an alternative definition, based upon Washington law:

> Instead of creating room to argue forever over whether a person has 'significant management responsibility . . . whose title does not reflect the nature of the position,' which appears to virtually require proof of fraud, I suggest simply replacing the awkward language with the simple concept that an officer includes any person in active control of the relevant functions of the entity.

Bundy, Comment 18, at 4.

Based upon the NPR comments, we have reconsidered the need to define the term "officer" in the Rule. As a preliminary matter, we continue to believe that individuals with management responsibility should disclose information about themselves under the Rule, even if they have not been assigned a specific corporate title. Indeed, tying Rule obligations to corporate titles would give license to scam artists to hide their identities and backgrounds by simply avoiding formal corporate titles. While this may lengthen disclosure documents for very large systems, we believe the benefits of the disclosure outweigh the costs. Nonetheless, we believe a simpler approach is warranted: we are persuaded that, in lieu of a definition of "officer," franchisors should disclose information about controlling company personnel directly in Item 2 itself, as PMR&W suggested above: "Disclose the position and name of the directors, trustees, general partners, officers, subfranchisors, and any other person who has or will have management responsibility relating to the offered franchises." This approach would streamline the Rule's definitions, while ensuring that all persons with management responsibility will make the appropriate disclosures, regardless of the presence or absence of a corporate title.

---

[232] Tricon, Comment 34, at 3.

V. PROPOSED SECTION 436.2: OBLIGATION TO FURNISH DOCUMENTS

Proposed section 436.2 of the final revised rule would address the scope of the Rule and franchisor's basic disclosure obligations, including the timing for making disclosures. It also would address liability for Rule violations.

A. Proposed Section 436.2: International Application of the Rule

1. Background

Currently, the Franchise Rule does not address whether pre-sale disclosure is required in international franchise sales. To clarify the issue, the Commission staff held a one-day, Rule Review public workshop conference on the international application of the Rule. The workshop participants generally agreed that the Commission should not seek to apply the Rule internationally. Accordingly, in the ANPR, the Commission stated that the "Rule Review record strongly supports modification of the Rule to clarify that international franchise sales are not within its purview." 62 Fed. Reg. at 9,119. Among other things, the Commission noted that: (1) the Commission did not contemplate international franchising when it promulgated the Rule; (2) the Rule's disclosures are aimed at the domestic market; (3) foreign franchise purchasers are sophisticated and do not need the Rule's protections; (4) attempting to comply with the Franchise Rule in foreign markets might result in franchisors disseminating inaccurate or misleading information; and (5) application of the Franchise Rule to international sales would unnecessarily impede competition.[233] In the NPR, the Commission adopted the same position, proposing to limit franchisors' disclosure obligations to "the offer or sale of a franchise to be located in the United States of America, its territories, or possessions."[234]

2. The record and recommendations

The commenters who addressed this issue overwhelmingly urged the Commission to limit the international application of the Rule for the reasons outlined in the ANPR.[235] Five commenters, however, would have the Commission enforce the Rule internationally,[236] raising essentially three points. First, many American foreign franchise sales contracts require disputes

---

[233] *Id.*

[234] 64 Fed. Reg. at 57,299-300.

[235] *E.g.,* PMR&W, Comment 4, at 1; 7-Eleven, Comment 10, at 2; IFA, Comment 22, at 5; AFC, Comment 30, at 1-2; Duvall, ANPR 19, at 2-3; SBA Advocacy, ANPR 36, at 9; Tifford, ANPR 78, at 7; NASAA, ANPR 120, at 8-9. *See generally* RR, Mar96 Tr.

[236] *See* Stadfeld, Comment 23, at 3; Brown, ANPRs 4, 6, 96, and 103; Stubbings, ANPR 21; Argentine Embassy, ANPR 132; Selden, ANPR 133, at 2-3.

to be resolved in the United States. It would be inconsistent for a franchisor to subject a foreigner to American law and American courts without simultaneously extending the benefits of American law, namely pre-sale disclosure.[237] Second, limiting the Rule's applicability to domestic franchise sales would mean that American citizens who purchase a franchise abroad from an American franchisor would not be protected by American law.[238] Third, the Commission has jurisdiction over foreign franchise sales and should not willingly restrict its own jurisdiction.[239]

In contrast, two commenters urged the Commission to limit the scope of the Rule even further to exclude franchise sales in American possessions and territories.[240] For example, Marriott asserted that the same policy concerns raised in the ANPR about applying the Rule internationally are also relevant to American possessions and territories such as Puerto Rico. Marriott apparently treats such locations as foreign countries. It contended that furnishing prospective franchisees in this context with a copy of the franchisor's disclosure document may be irrelevant or misleading.[241]

Based upon the record, the staff recommends that the Commission limit the international scope of the Rule as proposed in the NPR. Nothing in the record to date negates the Commission's tentative findings, as set forth in the ANPR and NPR, that the Rule's disclosure obligations in the international sales context are unnecessary, may be misleading, and may impede competition. For example, none of the commenters have identified specific problems or offered evidence showing that American companies selling franchises internationally engage in fraud or deception that would require Commission intervention. To the contrary, the record strongly supports the view that foreign franchise sales generally involve sophisticated investors who are represented by counsel or who otherwise can protect their own interests.[242]

It is also clear that the Commission developed the Franchise Rule in response to problems occurring in the domestic market.[243] There is no evidence in the record that a disclosure

---

[237] Brown, ANPR 6, at 2; Argentine Embassy, ANPR 132; Selden, ANPR 133, at 2-3.

[238] Stadfeld, Comment 23, at 3; Selden, ANPR 133, at 2. *See also* Stubbings, ANPR 21.

[239] Brown, ANPRs 4, at 3; 6 at 2; 103, at 15-16.

[240] J&G, Comment 32, at 3; Marriott, Comment 35, at 4-5.

[241] Marriott, Comment 35, at 4-5.

[242] For a more detailed discussion of the international sales issue, see NPR at 64 Fed. Reg. at 57,299-300.

[243] After reviewing the Commission's Rule and UFOC Guidelines, H&H observed that many of the provisions are limited to disclosures involving the domestic market. For example, UFOC

document addressing the American market would benefit prospective investors operating overseas. Just the opposite appears to be true: such disclosures may be irrelevant and potentially misleading when applied to a foreign franchise purchase due to the vast differences between American and foreign markets, cultures, and legal systems.[244] Risks to the investor would arise primarily from economic conditions and cultural values in those countries, not in the United States. To be relevant, a franchisor arguably would have to prepare individual disclosure documents tailored to each specific foreign market. Not only would such a requirement put American franchisors at a competitive disadvantage with franchisors from countries lacking comparable disclosure regulations, the minimal benefits of such a requirement are not likely to outweigh the extraordinary costs and burdens involved.[245]

At the same time, we reject the suggestion that franchise sales in American territories and possessions should fall outside the Rule's ambit. Section 4 of the FTC Act defines "commerce" to mean:

> commerce among the several states or with foreign nations, or in any territory of the United States or in the District of Columbia, or between any such territory and another, or between any such territory and any state or foreign nation, or between the District of Columbia and any state or territory or foreign nation.

15 U.S.C. § 44. Further, in various enabling statutes giving the Commission rulemaking authority, Congress specifically defined "state" to include Puerto Rico and other territories and possessions. For example, the Telemarketing And Consumer Fraud and Abuse Prevention Act, defines the term "state" to mean "any State of the United States, the District of Columbia, Puerto Rico, the Northern Mariana Islands, and any territory or possession of the United States." 15 U.S.C. § 6106(3).[246] In light of Congress' intent to cover American possession and territories

---

Item 20 refers to the number of franchise sales "in this state." The firm added: "Other disclosures about the franchise offering, including litigation and bankruptcy history, franchisor's and franchisee's obligations, royalty rates, initial investment, fees, and trademarks, are U.S.-specific." H&H, ANPR 28, at 3-4.

[244] *E.g.,* Miolla, 11Mar96 Tr, at 74-79; Shay, *id.* at 84-85; Forseth, *id.* at 103; Papadakis, *id.* at 139; Zwisler, *id.* at 163-64. *See also* Konigsberg, *id.* at 97 (franchisees in foreign countries look to their own laws, not to anything contained in a U.S. disclosure document).

[245] *See* Cendant, ANPR 140, at 4-5 ("Creating a disclosure document for . . . international master license transactions . . . would be nightmarish. . . . The cost of compliance would be high and American franchisors placed at an extreme disadvantage when competing with foreign franchisors.").

[246] *See also, e.g.,* Telephone Disclosure and Dispute Resolution Act, 15 U.S.C. § 5714(3) ("'State' means any state of the United States, the District of Columbia, Puerto Rico, The

in trade regulation rules, there are no compelling grounds to carve out an exception for the Franchise Rule.[247] Moreover, American possessions and territories rely on American law for protection, and coverage of the Franchise Rule is part of that protection.

B. Proposed Section 436.2(a): Timing For Making Disclosures

1. Background

Under the current Rule, franchisors and brokers must furnish prospective franchisees with disclosure documents at the earlier of two time periods: (1) the first personal meeting; or (2) "the time for making disclosures," which is defined as 10 business days before the execution of the franchise agreement or payment of any fees in connection with the franchise sale.[248] In the NPR, the Commission proposed to streamline this provision in two ways. First, the Commission proposed eliminating the first personal (face-to-face) meeting disclosure trigger.[249] The Commission reasoned that the first personal meeting trigger is 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." 64 Fed. Reg. at 57,301. Second, it proposed to replace the current 10 business day trigger with a 14 calendar-day disclosure trigger.[250] The Commission noted that the term "10 business days" may be unnecessarily confusing because franchisors must remember to exclude all federal holidays, some of which are not observed in every state. Moreover, in most instances, 10 business days as a practical matter will amount to 14 calendar days.[251]

Northern Mariana Islands, and any territory or possession of the United States."); Magnuson-Moss Warranty Act, 15 U.S.C. § 2301(15) ("The term 'state' means a State, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, the Canal Zone, or American Samoa."); Consumer Credit Protection Act, 15 U.S.C. § 1602(r) ("The term 'state' refers to any State, the Commonwealth of Puerto Rico, the District of Columbia, and any territory or possession of the United States.").

[247] Franchises located in possessions and territories are also governed by American tax law and accounting principles. Franchise sales in the territories, therefore, have more in common with those in the fifty states, than with sales in foreign countries. Exempting franchise sales in American territories and possessions, moreover, could lead to the creation of conflicting laws, which clearly cuts against Congressional intent in this field.

[248] 16 C.F.R. §§ 436.1(a), 436.2(g), and 436.2(o).

[249] 64 Fed. Reg. at 57,300.

[250] *Id*. at 57,301.

[251] *Id*.

2. The record and recommendations

a. First personal meeting

Franchisors and their representatives overwhelmingly supported eliminating the current Rule's first personal meeting disclosure trigger.[252] These commenters asserted that the first personal meeting trigger has become obsolete in the electronic age, where even large investments are made by telephone or via the Internet.[253] In contrast, franchisee advocates favored retaining the first personal meeting requirement. For example, Alaska Turner observed that:

> The ability to obtain disclosure early on in the purchase process is almost the only point of strength that a prospective franchisee has in the negotiation process. The ability to request a UFOC or disclosure document for review at an early stage in the negotiation, and thereby control at least the beginning of the timing of the sales process, is the only potential advantage that a prospective franchisee may get.

Turner, Comment 13, at 1. She urged the Commission to require disclosure after the franchisor has spent a set amount of time with a prospective franchisee. *Id*. at 2.

Eric Karp, a franchisee advocate, added that there is no basis to believe that personal meetings will completely become a thing of the past. According to Mr. Karp, eliminating the current first personal meeting disclosure trigger:

> is a dangerous and unnecessary move that will increase the opportunities for fraud in the sales process. It will allow the franchisor to conduct discussions with a franchisee about the purchase of a franchise over an extended and theoretically unlimited period of time . . . . During this period, the franchisee is likely to become heavily invested in the transaction and will be induced to make the purchase decision without the disclosure document. The 14 day cooling off period will then start when the franchisee has already decided to make the investment.

---

[252] *See, e.g.,* PMR&W, Comment 4, at 1; Holmes, Comment 8, at 3; NFC, Comment 12, at 13; NASAA, Comment 17, at 3; Marriott, Comment 35, at 9. *See also* Duvall, ANPR 19, at 3; Baer, ANPR 25, at 6; Tifford, ANPR, 18Sept97 Tr, at 158-59.

[253] *E.g.,* IFA, Comment 22, at 9; Stadfeld, Comment 23, at 4. Kennedy Brooks, a participant at the staff's New York City public workshop conference, observed 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, ANPR, 18Sept97 Tr, at 160. *See also* NCL, ANPR 35, at 4-5; SBA Advocacy, ANPR 36, at 9; IL AG, ANPR 77, at 3-4.

Karp, Comment 24, at 5-6.

Howard Bundy, who also opposed the elimination of the first personal meeting trigger, suggested an alternative approach: "the Commission should require franchisors to furnish prospects with a summary disclosure document at the first written communication." Bundy, Comment 18, at 5-6.

The staff recommends that the Commission eliminate the personal meeting trigger, as proposed in the NPR. We believe that the Rule should contain a bright-line disclosure trigger so that franchisors do not have to guess when they must furnish disclosures. The proposed 14-day trigger would accomplish that goal. In reaching this conclusion, we note that the personal meeting trigger alone does little to ensure that a prospective franchisee will receive disclosures early in the sales process.[254] While at the time the Rule was promulgated it may have been routine, or perhaps necessary, to have a face-to-face meeting early on, that is no longer true. Nowadays, a franchisor and a prospect may have numerous telephone conversations or send documents to each other via fax or mail long before any personal meeting takes place.

Nonetheless, we have considered the commenters' arguments supporting early disclosure, as well as their fears about "pre-conditioning" of prospective franchisees.[255] To address these concerns, we believe another approach is warranted. We recommend that the Commission adopt a new prohibition barring franchise sellers from refusing to honor a prospective franchisee's reasonable request for a copy of the franchisor's disclosure document during the sales process. We are not suggesting that a franchisor must tender a disclosure document to any consumer who may desire a copy. Rather, this prohibition would apply where the parties have already conducted specific discussions or negotiations or otherwise taken steps to begin the sales process.

---

[254] In the Final Interpretive Guides, the Commission acknowledged that the term "first personal meeting" is imprecise:

> Even where a face to face meeting occurs, it is not necessarily a "first" personal meeting. In interpreting this term, the Commission will consider such factors as whether the franchisor clearly indicated at the outset of the discussion that it was not prepared to discuss the possible sale of a franchise at that time, whether the meeting was initiated by the prospective franchisee rather than the franchisor, whether the meeting was limited to a brief and generalized discussion and whether earnings claims were made. The Commission believes that by using common sense precautions, franchisors can defer the first personal meeting until such time as they are prepared to provide the required disclosures.

44 Fed. Reg. at 49,970.

[255] *See also* SBP, 43 Fed. Reg. at 59,639 ("[O]nce a prospect has been 'hooked,' it is difficult, if not impossible, to 'extricate himself.'").

We believe this approach would preserve the goal of early disclosure in the sales process without reliance on the obsolete personal meeting trigger. It also would likely impose only a *de minimis* burden, if any, on franchisors, who presumably would have a disclosure document already prepared when discussing a sale with a prospective franchisee.

b. Fourteen calendar days

Commenters who addressed this issue unanimously agreed that the proposed 14-day disclosure trigger is clearer than the current 10 business day trigger.[256] Accordingly, we recommend that the Commission substitute the term "14 days" for "10 business days," as proposed in the NPR. David Holmes, however, urged the Commission to clarify further how to count the 14 days to "resolve any question as to whether or not the day on which the documents are delivered, or the day on which they are signed, may be counted for purposes of compliance with the Rule." Holmes, Comment 8, at 3.[257] We propose that the Commission address this concern in the Compliance Guides. Specifically, the 14 days commence the day after delivery of the disclosure document and that the signing of any agreement or receipt of payment can take place 15 days later, essentially guaranteeing prospective franchisees at least a full 14 days in which to review the disclosures.[258]

c. Third-party payments and agreements

Under the NPR proposal, franchisors would furnish their disclosures at least 14 days "before the prospective franchisee signs a binding agreement or pays any fee in connection with the proposed franchise sale." 64 Fed. Reg. at 57,333. A few commenters voiced concern about the meaning of the terms "binding agreement" and "pays any fee."

In his comment, Howard Bundy urged the Commission to broaden the Rule so that any payment made by a prospective franchisee in connection with the franchise sale, such as travel expenses, would trigger the franchisor's disclosure obligation. He voiced concern that prospective franchisees may risk losing significant sums of money to pursue a franchise before they receive any disclosures about the franchise offer. Mr. Bundy would modify the proposed disclosure trigger to require franchisors to furnish disclosure documents at least 14 days before the prospective franchisee signs a binding agreement, pays any fee in connection with the proposed franchise sale, or is required to travel or make other financial commitments as a precondition to receiving additional information. According to Mr. Bundy, this would:

---

[256] *E.g.,* Baer, Comment 11, at 10; NFC, Comment 12, at 13; AFC, Comment 30, at 2; Marriott, Comment 35, at 9.

[257] *See also* Baer, Comment 11, at 10.

[258] This approach is consistent with current industry practice. *See, e.g.,* "calendar" at www.msaworldwide.com (Aug.12, 2003).

> further the goal of the Commission of providing meaningful disclosure *before* the prospective franchisee makes an investment decision. When cash is flowing from a prospective investor's pocket at the direction of a franchisor or franchise seller, it matters not that it is flowing to some third party. It is still a required investment of resources as a condition of obtaining the perceived valuable franchise rights.

Bundy, Comment 18, at 5.

On the other hand, H&H and Tricon urged the Commission to narrow the 14-day trigger. Focusing on the "binding agreement" prong, they maintained that the disclosure obligation should commence 14 days before the prospective franchisee signs a binding agreement "with the franchisor or an affiliate of the franchisor." H&H, for example, stated that these limiting words are needed because "the franchisor cannot control whether a prospective franchisee proceeds to commit with independent third parties (e.g., lessor of real estate) before expiration of the cooling off period." H&H, Comment 9, at 21.[259]

Based upon the record, we recommend that the Commission revise the proposed 14-day disclosure trigger as follows. First, we recognize that the current Rule defines "time of making of disclosures," in relevant part as:

> ten (10) business days prior to the earlier of (1) the execution by a prospective franchisee of any franchise agreement or any other agreement imposing a binding legal obligation on such prospective franchisee, about which the franchisor, franchise broker, or any agent, representative, or employee thereof, knows or should know, in connection with the sale or proposed sale of a franchise, or (2) the payment by a prospective franchisee, about which the franchisor, franchise broker, or any agent, representative, or employee thereof, knows or should know, of any consideration in connection with the sale or proposed sale of a franchise.

16 C.F.R. § 436.2(g). Thus, under the current Rule franchisors must make disclosure not only if they sign agreements with a prospective franchisee or direct a prospective franchisee to pay a third party, but if they know that a prospective franchisee will sign an agreement with, or make a payment to, a third party.[260]

In light of our proposal that the Commission prohibit franchisors from failing to furnish disclosures earlier in the sales process upon reasonable request, we find the current, broad disclosure trigger no longer necessary. If a prospective franchisee is directed to make third-party payments or enter into third-party agreements to advance the franchise sale, the prospect can always ask for a disclosure document before undertaking such obligations. Accordingly, we

---

[259] Tricon, Comment 34, at 3-4.

[260] *See also* Final Interpretive Guides, 44 Fed. Reg. at 49,970.

agree with H&H and Tricon that the disclosure trigger should be limited to where the franchisor directs prospective franchisees to make payments or enter into agreement with the franchisor or an affiliate to advance the franchise sale.

C. Proposed Section 436.2(b): Modified contract review period

1. Background

The Franchise Rule currently requires franchisors and brokers to furnish prospective franchisees with a copy of the completed franchise agreement at least five *business* days before the date of execution.[261] In the NPR, the Commission proposed retaining the franchise agreement disclosure requirement, while reducing the number of days to just "five days."[262]

2. The record and recommendations

In response to the NPR, commenters generally voiced two views. Franchisees and their supporters, as well as the IL AG, generally favored the franchise agreement disclosure requirement, but urged the Commission to adopt a longer time period, such as seven days. The IL AG, for example, maintained that "[it] is not just the review time that is important, it is having time to contact the prospect's advisor and schedule a meeting." IL AG, Comment 3, at 5. Similarly, Seth Stadfeld stated his belief that a prospect should have "the full week of consideration that they have enjoyed in the past." Stadfeld, Comment 23, at 4. He saw "no benefit to them to cut down on the time that they had to assess whether or not to proceed with the franchise transaction and any drawback for franchisors is *de minimis*." *Id*.

On the other hand, some franchisors and their supporters, as well as NASAA, urged the Commission to eliminate the contract review period altogether. PMR&W, among others, asserted that the resulting delay from the mandatory disclosure period often harms prospective franchisees:

> In practice, the 5-day rule typically hurts rather than aids franchisees, since the "price" of an additional concession by the franchisor is an additional 5-day delay. Franchisees often are more time sensitive than franchisors, either because of a financing commitment or a lease option that might be expiring or the need to attend a training program. As a result, the 5-day rule can discourage a franchisee from requesting last-minute changes. Thus, the current provision, especially now

---

[261] 16 C.F.R. § 436.1(g).

[262] At the same time, the NPR solicited comment on whether a five-day contract review period would provide prospective franchisee with a sufficient opportunity to review the contract. 64 Fed. Reg. at 57,329.

> that business opportunities are not covered, has little potential benefit to either franchisor or franchisee and may, in fact, discourage, rather than promote, last minute negotiations.

PMR&W, Comment 4, at 4.[263] Similarly, Marriott noted that the timing of closing the deal is often critical to the franchisee:

> as loan commitments may expire, options to acquire sites may expire or financial commitments may be required to prevent the site from being sold or leased to a different entity. Securities offerings may be held up until franchise agreements are executed. Interest rates may change so as to make a project unavailable unless commitments are promptly made.

Marriott, Comment 35, at 9-10. For similar reasons, the NFC urged the Commission to clarify the five-day provision to exclude changes to the franchise agreement made "less than five days prior to the execution thereof at the request of the franchisee." NFC, Comment 12, at 14.[264]

Upon further reflection, the staff recommends that the Commission eliminate the contract review period, except in limited circumstances. In our view, the current franchise agreement disclosure period was intended to advance two goals. First, it better ensures that prospective franchisees will have time to review and understand the franchise agreement before they undertake significant financial and legal obligations. Second, it prevents fraud by discouraging a franchisor from unilaterally substituting pages or otherwise altering the contract presented to the prospective franchisee for signing.

We find that the first concern – providing time to study the franchise agreement – is already served by the Rule's basic disclosure requirement. Attached to each disclosure document is a copy of the franchisor's basic agreement. At the very least, this document enables prospects to become familiar with the basic terms and conditions governing the franchise system. Based upon our law enforcement experience, it also appears that franchisors routinely use standardized franchise agreements. Last-minute changes to a franchise agreement, therefore, most likely arise at the franchisee's initiation. When a prospective franchisee is the party introducing contract modifications, re-disclosure by the franchisor is hardly warranted.

Further, we do not believe that the Rule should impede a prospective franchisee's ability to negotiate agreement changes. The delay inherent in a mandatory contract review period may

---

[263] *See also* IFA, Comment 22, at 9; J&G, Comment 32, at 6; Marriott, Comment 35, at 9; GPM Rebuttal, Comment 40, at 2.

[264] If the Commission decides to retain a contract review provision, then several franchisor supporters would support a five-day period. *E.g.,* PMR&W, Comment 4, at 4; NFC, Comment 12, at 13; BI, Comment 28, at 3; AFC, Comment 30, at 2.

discourage negotiations if a prospective franchisee believes that he or she will suffer as a result of the delay. As Marriott noted, the timely signing of a franchise agreement may be a prerequisite for other parts of the overall deal, such as obtaining leases and loans. Indeed, in most instances a prospective franchisee is in the best position to judge how much review time is warranted and can demand additional review time, if desired.

Nonetheless, we are concerned about the second reason for advanced disclosure of the franchise agreement – fraud. A franchisor should not be able to substitute at the last minute provisions that differ from those in the agreement previously attached to the disclosure document. To address potential fraud, we propose two solutions. First, we recommend that the Commission limit the contractual review provision to situations where the franchisor has materially altered the terms and conditions of the standard contract attached to the disclosure document. This would exclude situations where the only differences between the standard contract and the completed contract are "fill-in the blank" provisions, such as the date, name, and address of the franchisee. It would also exclude instances where deviations from the standard contract were initiated at the prospective franchisee's request. Further, where the contract review period applies, we also agree with the commenters above that the review period should be a full seven days. Accordingly, we recommend that the Commission substitute "seven days," for "five business days," paralleling our recommendation above to substitute 14 calendar-days for "10 business days."

Second, we recommend that the Commission target potential fraud directly by adopting a new prohibition. Specifically, we propose prohibiting a franchisor from unilaterally substituting provisions or pages in a franchise agreement, unless the franchisor first alerts prospective franchisee's about the changes in a reasonable time before he or she signs the agreement. Accordingly, we recommend that the Commission revise the contract review period requirement to read:

> [It is an unfair or deceptive practice] for any franchisor to alter unilaterally and materially the terms and conditions of the basic franchise agreement attached to the disclosure document without furnishing the prospective franchisee with a copy of the revised franchise agreement, and any related agreements, at least seven days before the prospective franchisee signs the revised franchise agreement. Changes to a franchise agreement that result solely from negotiations initiated by the prospective franchisee do not trigger this seven-day period.

D. Proposed Section 436.2(c): Furnishing Disclosures

1. Background

In the NPR, the Commission proposed including additional guidance in the Rule on what constitutes "furnishing" disclosures. Such guidance is needed given the wide array of disclosure formats and delivery mechanisms in the current marketplace. Among other things, the NPR

proposed that franchise sellers wishing to send documents by mail should send them by first class mail and add three days to ensure timely delivery:

> 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 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 franchisee by that date.

64 Fed. Reg. at 57,333.

2. The record and recommendations

The NPR proposal generated only limited comment. BI observed that the term "first class" mail is undefined, and it suggested that the Commission clarify the provision to read "first class U.S. mail." BI, Comment 28, at 4-5. The firm also suggested that the Rule specify the delivery requirements for private couriers (such as Federal Express) and telefax machines. BI also noted that franchisors will want to retain some proof of delivery in case of a dispute. To that end, the firm urged the Commission to "specify any specific documents or types of evidence which would qualify as valid evidence of the mailing date." *Id.* Finally, BI would revise the NPR provision to read "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 *required* date." *Id.* The firm also suggested that the Commission use the phrase "required date" consistently, rather than the term "specified date." *Id.*

The staff agrees that the Commission should broaden this Rule section to address other delivery mechanisms, such as private couriers and fax machines.[265] While we believe the term "hand-delivery" already includes couriers, we find it desirable to reference facsimile. In addition, the proposed Rule provision should use the phrase "required date" consistently. However, we stop short of recommending that the Rule set forth specific proof of delivery guidelines. A franchisor always has the burden of proof to show that it has complied with the Rule's obligation to furnish disclosures. The Rule should be as flexible as possible, allowing franchisors to keep records, and to offer proof, in the format that is most convenient to them.

Finally, the staff also proposes an additional modification to the NPR proposal. Specifically, we recommend that the Commission revise the NPR proposal to eliminate the

---

[265] As noted above, we also recommend that the Compliance Guides clarify that a representative may accept delivery of a disclosure document on behalf of a prospective franchisee.

reference to the consent of the prospective franchisee in connection with electronic disclosures. This is in keeping with our recommendations concerning electronic disclosures generally, as discussed below in section VII. So revised, proposed section 436.2(c) of the proposed revised Rule would provide:

> The franchisor has furnished the documents by the required date if: (1) a copy of the document was hand-delivered, faxed, emailed, or otherwise delivered to the prospective franchisee by the required date; (2) directions for accessing the document on the Internet were provided to the prospective franchisee by the required date; or (3) a paper or tangible electronic copy (for example, computer disk or CD-ROM) was sent to the address specified by the prospective franchisee by first-class U.S. mail at least three days before the required date.

E. Proposed Section 436.2(d): Liability

1. Background

Under the current Rule, franchisors and brokers are jointly and severally liable for furnishing disclosures.[266] The NPR proposed retaining the same standard:

> In connection with the offer or sale of a franchise . . . 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 in this subsection are satisfied if either the franchisor or other franchise seller furnishes the required documents to the prospective franchisee.

64 Fed. Reg. at 57,333.

The current Rule, however, does not specifically address liability for a disclosure document's content. Given that franchisors and franchise brokers currently are jointly and severally liable for furnishing disclosures, it is reasonable to assume that both franchisors and franchise brokers are also equally liable for ensuring that the contents of disclosure documents are complete and accurate. In the NPR, the Commission proposed to clarify the issue, stating that franchise sellers would be liable for the contents of a disclosure document if they knew or should have known of the violation.[267]

---

[266] 16 C.F.R. § 436.1(a). *See also* Final Interpretive Guides, 44 Fed. Reg. at 49,969.

[267] 64 Fed. Reg. at 57,301; 57,333.

2. The record and recommendations

a. Liability for furnishing disclosures

Except as previously noted above in our discussion of the "franchise seller" definition, no commenters voiced concern about liability for furnishing disclosures. Nonetheless, we recommend that the Commission narrow the scope of liability in the final revised Rule. When the Rule was promulgated, it was reasonable to hold brokers liable along with the franchisor for failing to furnish disclosures because brokers often made the first personal contact with prospective franchisees. Given our proposal eliminating the first personal meeting disclosure trigger, we believe it is no long necessary to retain the broker disclosure liability provision. In short, it is the franchisor that always retains ultimate liability for ensuring that prospective franchisees receive disclosures required by the Rule.[268] This proposal would also reduce inconsistencies with state law, which generally limits disclosure obligations to the franchisor.

b. Liability for content

A few commenters voiced concern about the NPR's proposed liability standard for the content of disclosure documents. John Baer, for example, stated that the NPR proposal imposes an "impossible" standard of liability:

> As anyone who has drafted an Offering Circular can testify, there is no certainty as to the nature of the information that has to be included in the various disclosure sections of the Offering Circular and reasonable persons often differ in good faith as to what has to be disclosed.

Baer, Comment 11, at 10. He suggested that the Commission revise the standard to "make it a violation for a franchisor to fail to use 'commercially reasonable good faith efforts' to disclose the required information." *Id.*

Similarly, Tricon stated that the proposal would result in all employees being potentially liable for Rule violations, even those employees who are not involved in any franchise sales. According to Tricon, an employee should not be liable, even if that person had actual knowledge, unless that person:

> (a) knew (or should have known) the legal significance of those facts, and (b) was in a position to influence the outcome of the matter. For example, a secretary could "know" that financial performance data was routinely provided to buyers, but neither know the significance of doing so nor be in a position to stop the practice.

---

[268] Franchise sellers would still be liable under Section 5 for their own misrepresentations, as well as subject to certain prohibitions, as discussed below at section X of this Report.

Tricon, Comment 34, at 6.[269]

In contrast, NASAA supported the view that franchisors and individual owners of franchisors should be held liable for Rule violations "regardless of whether they knew or should have known of the violation." NASAA, Comment 17, at 3.

The staff recommends that the Commission revise the content liability standard as follows. We first note that all Commission trade regulation rules implement Section 5 of the FTC Act and, therefore, should incorporate the standard of liability developed in Section 5 cases. Under Section 5 law, individuals will be held liable for a corporation's law violations if they participated directly in them or had the authority to control them.[270] Applying this principle to the Franchise Rule, we recommend that franchise sellers (for example, third-party brokers and franchisor employees) be liable for the content of a disclosure document if they either directly participated in the document's creation or had authority to control it.

VI. PROPOSED SECTIONS 436.3 - 436.5: THE DISCLOSURE DOCUMENT

The next sections of the Rule – proposed sections 436.3 - 436.5 – would set forth the substantive disclosures and attachments that franchisors must include in their disclosure documents. They begin with the cover page.

A. Proposed Section 436.3: Cover Page

1. Background

Under the Franchise Rule, a disclosure document begins with a cover page.[271] Among other things, the cover page informs prospective franchisees that they are receiving important information about the franchise offering and that they should seek advice from an advisor, such

---

[269] *See also* Baer, Comment 11, at 10.

[270] *E.g., FTC v. Amy Travel Servs., Inc.,* 875 F.2d 564, 573 (7th Cir.), *cert denied*, 439 U.S. 954 (1989); *FTC v. Atlantex Assos.,* 1987-2 Trade Case. (CCH), ¶ 67,788 at 59,255 (S.D. Fla. 1978), *aff'd*, 872 F.2d, 966 (11th Cir. 1989); *FTC v. Kitco of Nevada*, 612 F. Supp. 1282, 1292 (D. Minn. 1985). Under Section 5 case law, it is also clear that individual franchise salespersons are also directly liable for their own misrepresentations in connection with franchise sales. *See, e.g., J.K. Publ'ns,* 99 F. Supp. 2d at 1203 and n.67.

[271] 16 C.F.R. § 436.1(a)(21). *See also* UFOC Guidelines, Cover Page Instructions.

as a lawyer or an accountant. It also makes clear that the Commission has not checked the accuracy of any of the disclosures.[272]

During the ANPR proceeding, a few commenters offered various suggestions on how to improve the existing cover page. Teresa Heron, a "My Favorite Muffin" franchisee, suggested that the cover page include more background information on franchising, and on applicable franchise laws and enforcement policies. For example, the cover page would include a discussion of Section 5 (including the Commission's unfairness jurisdiction), state registration laws, the FTC's case selection criteria, and the absence of a private right of action to enforce the Rule. Ms. Heron would also insert additional sources of information on franchising, such as a reference to the FTC's home page.[273]

Several franchisees also contended 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. For example, Ms. Heron stated that the cover page's language "to protect you," implies "legitimacy, reliance, and veracity of the information contained in the disclosure document." Heron, ANPR 80, at 1.[274] Similarly, at the New York workshop conference, the AFA's President, Susan Kezios, asserted:

> I'd just like to support what you said about taking out the language to protect you because in many UFOCs and many FTC documents the only misrepresentation from many of our members' eyes is the implied promise on that FTC cover sheet saying we're going to help you out. There's an implied promise that the FTC is going to do something when, in fact, that's not what happens.

Kezios, ANPR, 18Sept97 Tr, at 10.[275]

---

[272] In the SBP, the Commission found that the burdens imposed by the cover page requirements are "minimal, that the benefits to be derived by prospective franchisees are great in terms of both putting prospective franchisees on notice as to the required disclosure obligations of franchisors and advising such franchisees as to the status of the disclosure statement (*i.e.*, that it has not been reviewed by the Commission and may contain erroneous and/or incomplete information)." 43 Fed. Reg. at 59,683.

[273] Heron, ANPR 80.

[274] *See also* Murphy, ANPR 2, at 2; Maloney, ANPR 38, at 1; Karp, ANPR, 19Sept97 Tr, at 89-90.

[275] *See also* Karp, ANPR, 19Sept97 Tr, at 89-90.

In addition, a few ANPR commenters urged the Commission to adopt various cover page risk factors. For example, Greg Gaither, a GNC franchisee, suggested that the cover page include a warning that encroachment – marketing in a franchisee's territory – is a risk that might severely affect a franchised outlet's performance.[276] Michael Garner would require franchisors to disclose how their contracts may be imbalanced: "[I]sn't it better to have an unbalanced franchisor/ franchisee relationship disclosed as such early on rather than buried in the legalese of a franchise agreement?" Dady & Garner, ANPR 127, at 3. Mr. Garner recommended that franchisors disclose up-front on the cover page: (1) if franchisees have no protected territory; (2) if franchisees can be terminated upon failing to comply with the franchise agreement; (3) if franchisees cannot transfer without prior approval; and (4) if the franchisor reserves the right to receive royalty payments even if it breaches obligations to provide support services.[277]

The NPR adopted several of these suggestions. The NPR proposed cover page would differ from the current cover page in four respects. First, the NPR cover page included additional background information for prospective franchisees to use in conducting their own due diligence investigation, such as references to the FTC's Web site and the Commission's *Consumer Guide to Buying a Franchise*.[278] This would enable prospective franchisees to find additional background information on franchising, pre-sale disclosure, and the Commission's law enforcement history.

Second, contemplating electronic disclosure, the NPR proposed that franchisors include on the cover page their principal email and home page addresses.[279] It would also require franchisors wishing to make disclosures electronically to add to the cover page a statement advising prospective franchisees to download the document for future reference, as well as how to receive a paper copy.[280]

Third, the NPR proposed eliminating information from the current cover page that might be misinterpreted as implying greater Commission oversight of franchising than is the case.[281]

---

[276] G. Gaither, ANPR 69, at 1. *See also* Kezios, 6Nov97 Tr, at 142 (suggesting that any disclosures about encroachment risks should be placed on the cover page).

[277] Dady & Garner, ANPR 127, at 3. *See also* Punturo, ANPR, 18Sept97 Tr, at 15 ("[I]t's important that when a prospective franchisee picks up a prospectus that risk factors are there right in the front so they can immediately see what concerns the regulators have had.").

[278] 64 Fed. Reg. at 57,301-02; 57,333.

[279] *Id.* at 57,302; 57,333.

[280] *Id*.

[281] *Id.* at 57,302.

Fourth, to promote greater uniformity with state disclosure laws, the NPR proposed that we adopt the UFOC Guidelines' cover page requirements,[282] in part. For example, the cover page would include the franchisor's name, logo, brief description of the franchised business, total purchase price as reflected in Item 5 (initial fees) and in Item 7 (estimated initial investment), and a notice that comparative information about franchising is available.[283]

Finally, in the NPR the Commission proposed permitting franchisors to include risk factors on the cover page, if required to do so under state law.[284] However, the Commission declined to adopt the two required UFOC Guidelines risk factors for choice of venue and choice of law.[285] The Commission observed that these two risk factors essentially repeat what franchisors already must disclose in Item 17 of the disclosure document.[286] Moreover, mandating the disclosure of these two risk factors on the cover page might incorrectly signal prospective franchisees that these are the most important risk factors to consider.[287]

2. The record and recommendations

The NPR's proposed cover page generated limited comment. For example, no commenters raised any concerns about: (1) adopting elements of the UFOC Guidelines' cover page; (2) requiring franchisors to include, if applicable, their email and primary home page addresses; or (3) eliminating arguably misleading information.[288] We, therefore, recommend that the Commission adopt these proposals in the final revised Rule. However, some commenters suggested the possible need for additional information. Others addressed electronic disclosures, references to Items 5 and 7, and risk factors. We address each of these issues below.

---

[282] *See generally,* UFOC Guidelines, Cover Page, Instructions.

[283] 64 Fed. Reg. at 57,301; 57,333.

[284] *Id.* at 57,301-02; 57,333. *See also* Tifford, ANPR, 18Sept97 Tr, at 15-16 (suggesting that the Commission accommodate risks factors developed by the individual states).

[285] 64 Fed. Reg. at 57,301-02. *See also* UFOC Guidelines, Cover Page, Instructions, iv.

[286] 64 Fed. Reg. at 57,301. *See* Cendant, ANPR 140, at 3 (suggesting that risk factors belong in the Item 17 disclosures on franchise relationship issues).

[287] 64 Fed. Reg. at 57,302.

[288] We recommend, however, that the Commission modify the current Rule requirement that franchisors state that the Commission has not checked the disclosures for accuracy. We would broaden the statement to "no government agency has verified the information in this document." This statement, warning prospective franchisees not to take the disclosures at face value, references both state and federal approaches.

a. Additional information

In response to the NPR, the AFA suggested that the Commission warn prospective franchisees that they are not purchasing their own business. To that end, the AFA would include the following warning on the cover page: "You will not own your own business. You will lease the rights to sell [company's name] goods [services] to the public under the [company's name] tradename and trademarks. This agreement will expire and you will have no rights to continue in operation upon expiration." AFA, Comment 14, at 4.

The AFA also urged the Commission to strengthen the language advising prospects to show the disclosures to an advisor, offering the more emphatic language: "Show your contract and this disclosure document to an attorney, preferably one who practices franchise law. Show the disclosure document, in particular the sections regarding your financial obligations and the franchisor's financial statements, to an accountant." *Id.* at 4.[289]

We agree in principle with the AFA's suggestion that prospective franchisees should be better informed about the nature of franchising. However, the appropriate vehicle for educating prospects is through consumer education materials, not the Rule itself. In order to streamline the Rule, while reducing inconsistencies between federal and state disclosure laws, we have carefully weighed all suggestions to expand the Rule. In general, where we can advance our goals through increased consumer education, we see no reason to broaden the Rule itself. This is particularly true in the case of the cover page because it will reference the Commission's *Consumer Guide to Buying a Franchise,* which already includes the advice the AFA has suggested.

b. Electronic disclosures

As noted above, the NPR proposed that a franchisor wishing to make disclosures electronically should insert the following additional statement in the cover page:

> 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].

64 Fed. Reg. at 57,333.

In response to the NPR, the NFC voiced concern that this proposal would require franchisors to provide the name, address, and telephone number of a particular employee who could be contacted for a paper copy of the disclosure document. The NFC stated that a number of

---

[289] *See also* Murphy, ANPR 2, at 2.

employees may serve that purpose and suggested, instead, that franchisors disclose the title of the position, rather than name of an individual.[290]

As discussed later in this Report, we have revised our views concerning electronic disclosures generally, concluding, among other things, that creating a right to obtain a paper copy of a disclosure document is unwarranted.[291] We agree with the commenters who suggested that the Commission permit franchise sales entirely through electronic means, without resorting to paper transactions. At the same time, we recommend that the Commission permit franchisors voluntarily to state if they make disclosures available to prospective franchisees in other media. Specifically, we recommend that the Commission permit franchisors to include the following statement in their cover pages: "You may wish to receive your disclosure document in another format that is more convenient for you. To discuss the availability of disclosures in different formats, contact [name or office] at [address] and [telephone number]." In drafting this proposal, we have recognized the NFC's concern that there may be a number of individuals within a franchise system that might be able to assist a prospect in receiving a disclosure document. To provide as much flexibility as possible, we recommend that the Commission permit franchisors to designate either a specific individual or office as a contact.

c. References to Item 5 and Item 7 fees

In the NPR, the Commission proposed that the cover page adopt the UFOC Guidelines' requirement that franchisors refer to "the total amounts in Item 5 (Initial Fees) and Item 7 (Estimated Initial Investment) of the disclosure document." 64 Fed. Reg. at 57,301.[292] This would provide prospective franchisees up-front with a summary of their expected investment.

In response to the NPR, BI stated that it is misleading to reference Item 5 on the cover page. According to the firm, the cover page should put prospects on notice of the initial franchise fee that must be paid for the right to commence business under the mark. BI suggested that the inclusion of the broader Item 5 initial fees would cloud the issue, making comparisons of initial franchise fees among competitors difficult: "For example, in cases where a franchisor sells or leases the premises of the franchised business to the franchisee, this payment would need to be included in Item 5, but would severely distort the amount of the initial franchise fee disclosed on the cover page." BI, Comment 28, at 5.

We believe the proposed cover page's reference to Item 5 fees is proper. The purpose of cover page's cost disclosure is not simply to indicate the fee paid to the franchisor for using the franchisor's mark, but to disclose the total costs paid to the franchisor associated with

---

[290] NFC, Comment 12, at 27.

[291] *See* below at section VII.

[292] *See also* UFOC Guidelines, Cover Page, 5.

commencing business operations.[293] In fact, limiting the disclosure to the initial franchise fee alone could be misleading because it may understate the totality of fees that must be paid to the franchisor in order to start the business. We believe that the proposed cover page cost disclosures will better enable prospective franchisees to assess their full potential business costs, and ultimately their financial risk, than a disclosure limited to the initial franchise fee alone.[294] At the same time, we recognize that it is possible to achieve the goal of informing prospective franchisees about the investment by referring to Item 7 alone – Initial Investment. Indeed, Item 5 is basically a subset of Item 7. Nonetheless, in an effort to reduce inconsistencies between federal and state law, we recommend that the Commission adopt a modified version of the UFOC cover page reference to Item 5 and Item 7, as follows: "The total investment necessary to begin operation of a [franchise system name] franchise is [the total amount of Item 7], including [the total amount in Item 5] that must be paid to the franchisor."

d. Risk factors

Finally, GPM opposed the NPR proposal that would permit states to impose additional risk factors on the cover page.[295] The firm suggested that a state should be permitted to require additional information only in a state-specific addendum.

We reject GPM's suggestion that the Commission preempt state risk factors or otherwise permit them only in a state-specific addendum. Below at section XI, we address preemption, concluding that the Commission should permit the states the greatest latitude in fashioning franchise disclosure laws. In keeping with that goal, we believe that it is proper to permit franchisors to add to an FTC disclosure document in order to comply with non-preempted state law. We also believe that it is proper to permit the states and franchisors the greatest flexibility concerning how to include state-specific information, be it in an addendum, separate cover page, or otherwise.

---

[293] For the same reason, we also recommend that the title of Item 5 be revised to read "Initial Fees Paid to the Franchisor," as discussed below at section VI.G.

[294] BI's concern would be valid if the cover page required the disclosure of only Item 5 (initial fees), but not the Item 7 (estimated initial investment). For example, a franchisor who leases premises to a franchisee would include the lease payment in the Item 5 initial fees, whereas a franchisor who requires a franchisee to lease premises from a third party would not include such payment in Item 5. Arguably, this would seem to inflate the first franchisor's Item 5 initial fees. However, lease payments to third–parties would nonetheless appear in Item 7. Accordingly, Item 5 and Item 7, considered together, enable prospective franchisees to compare initial expenses across franchise systems.

[295] GPM Rebuttal, Comment 40, at 4.

B. Proposed Section 436.4: Table of Contents

1. Background

In the NPR, the Commission proposed a table of contents that would track the text and order set forth in the UFOC Guidelines.[296] The Commission, however, proposed modifying the titles of four disclosure items as follows: (1) Item 7 would be changed from "Initial Investment" to "Estimated Initial Investment"; (2) Item 11 would be changed from "Franchisor's Obligations" to "Franchisor's Assistance, Advertising, Computer Systems, and Training"; (3) Item 19 would be changed from "Earnings Claims" to "Financial Performance Representations; "and (4) Item 20 would be changed from "List of Outlets" to "Outlets and Franchisee Information." 64 Fed. Reg. at 57,302.

2. The record and recommendations

In response to the NPR, no commenters raised any concerns about these four proposed changes to table of contents. Therefore, we recommend that the Commission adopt them in the proposed final revised Rule. We further recommend an additional three modifications to the table of contents based upon the NPR comments.[297]

Warren Lewis recommended that the Commission change the title of Item 5 from "Initial Franchise Fee" to "Initial Fees" so that the title will more accurately describe the actual subject matter of the Item.[298] Mr. Lewis further suggested that the title of Item 23 be changed from "Receipt" to "Receipts" (one for the franchisee and one for the franchisor). Further, NASAA observed that Item 6 is labeled "Other Fees," yet the text of Item 6 says "Recurring or Occasional Fees." It recommended the Commission use the phrase "other fees" consistently throughout the Rule.[299] The staff believes that these additional revisions are sound and recommends that the Commission adopt them in the final revised Rule as well. However, with respect to Item 5, we would take the additional step of clarifying that the initial fees under discussion are those "paid to the franchisor."

---

[296] Currently, the table of contents is set forth in a footnote at the back of the Rule. *See* 16 C.F.R. Part 436, note 3.

[297] We also recommend that the title to Item 1 ("The Franchisor, its Parent, Predecessors, and Affiliates") be changed to "The Franchisor, and any Parent, Predecessors, and Affiliates."

[298] Lewis, Comment 15, at 11.

[299] NASAA, Comment 17, at 4.

C. Proposed Section 436.5(a)
Item 1: The Franchisor and any Parent, Predecessors, and Affiliates

1. Background

Currently, the Franchise Rule requires the disclosure of background information on the franchisor, as well as any parent and affiliates.[300] The NPR proposed revising these disclosures to mirror Item 1, the parallel UFOC Guidelines' disclosure.[301] So revised, the NPR would expand the current Rule disclosures in three material respects. First, franchisors would disclose information about their predecessors for the 10-year period immediately before the close of the franchisor's most recent fiscal year.[302] This would prevent franchisors from hiding prior misconduct and avoiding disclosure obligations simply by assuming a new corporate identity.[303] Second, franchisors would disclose any regulations specific to the industry in which the franchise business operates, such as any necessary licenses or permits,[304] which may affect the franchisee's

---

[300] *See* 16 C.F.R. §§ 436.1(a)(1), (3), and (6). The Commission has long recognized the materiality of franchisor background information. In the SBP, the Commission concluded that:

> the failure to disclose such material information . . . may mislead the franchisee as to the business experience of the parties with whom he or she is dealing and . . . could readily result in economic injury to the franchisee because of the franchisee's dependence upon the business experience and expertise of the franchisor.

43 Fed. Reg. at 59,642. Other Commission trade regulation rules similarly require identity disclosures. *E.g.*, Wool Products Labeling Act, 16 C.F.R. § 300.14 (recognizing that names on a label may mislead consumers about the actual manufacturer); Fur Products Labeling Act, 16 C.F.R. § 301.43 (recognizing that corporate name may mislead consumers about the character of the product).

[301] 64 Fed. Reg. at 57,302.

[302] *See* UFOC Guidelines, Item 1.

[303] *See FTC v. Morrone's Water Ice, Inc.,* No. 92-3720 (E.D. Pa. 2002) (company allegedly reincorporated as a "licensor" following an adverse arbitration decision). *See also 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). *Cf. FTC. v. Jani-King, Int'l,* No. 3-95-CV-1492-G (N.D. Tex. 1995) (company allegedly conducted business through multiple regional corporations thereby avoiding certain disclosures).

[304] *See* UFOC Guidelines, Item 1E Instructions, vi. In the NPR, the Commission attached a footnote to this proposal that would explain in greater detail the types of laws that franchisors

operating costs and ability to conduct business.[305] Third, franchisors would describe the general competition prospective franchisees are likely to face. This disclosure would better ensure that the prospective franchisee can understand the likely economic risks in purchasing a franchise.[306] At the same time, proposed Item 1 would differ from UFOC Item 1 by retaining the current Rule's disclosure of parent information.[307]

2. The record and recommendation

In response to the NPR, a few commenters questioned the scope of proposed Item 1. Specifically, commenters voiced concern about the proposed disclosure of parents, predecessors, and competition. We address each of these issues below.

a. Parent information

The NPR's proposal to retain the disclosure of parent information generated several comments, both in support and opposition. Dr. Spencer Vidulich, a Pearle Vision franchisee, told us that such a disclosure is material to prospective investors. He related that his franchisor was

---

must disclose under this provision. No comments were submitted in response to this proposal. Nonetheless, the staff recommends that the proposed explanatory footnote be deleted and moved to the Compliance Guides, where the issue can be discussed in full. This approach is consistent with our goal of streamlining the Rule, where possible.

[305] *E.g., FTC v. Car Checkers of Am., Inc.*, Bus. Franchise Guide (CCH) ¶ 10,163 (D.N.J. 1993) (failure to disclose state restrictions on the sale of service contracts); *U.S. v. Lifecall Sys. Inc.,* No. 90-3666 (D.N.J. 1990) (failure to disclose state registration requirements). *Cf.* Funeral Rule, 16 C.F.R. § 453.3 (it is a misrepresentation to mischaracterize state or local funeral industry laws).

[306] *See* UFOC Guidelines, Item 1E Instructions, v. Throughout the SBP, the Commission recognized that potential economic risks to consumers are material. *E.g.,* 43 Fed. Reg. at 59,650-51 (bankruptcy); at 59,662 (sales restrictions); at 59,668 (post-term covenants not to compete). A competition disclosure also appears to be warranted in light of several franchisee complaints about competition issues. *E.g.,* Packer, ANPR 10 (franchisor has opened franchisor-owned stores to compete with its own franchisees); Manuszak, ANPR 13 (competition from encroachment); Gray, ANPR 22 (franchisor sold to competing system); Lopez, ANPR 123 (competition from franchisor's co-branded outlets).

[307] 16 C.F.R. § 436.1(a)(1)(i). As explained in the NPR, the Commission believes that information about a franchisor's parent may be material to a prospective franchisee. 64 Fed. Reg. at 57,302-03. For that reason, the Commission stated in the SBP that it would require the disclosure of information about a parent, even though it recognized that the UFOC Guidelines contained no comparable disclosure requirement. *See* 43 Fed. Reg. at 59,639.

bought by Cole National Corporation, which operates leased optical departments in Sears stores. In this instance, the disclosure of parent information would alert prospective Pearle Vision franchisees that their franchisor is owned by a company that operates competing outlets.[308] Franchisor representatives – including PMR&W, H&H, and J&G – did not deny that the disclosure of parent information may be material; rather, they asserted that a separate disclosure is unnecessary given the NPR's broad definition of "affiliate."[309]

The staff recommends that the Commission retain the current Rule's parent disclosure requirement. As a preliminary matter, we acknowledge arguments to the contrary. First, a parent's activities are often distinct from those of the franchisor: indeed, a parent may not engage in franchising at all. In addition, a parent disclosure arguably may be misleading because a prospective franchisee might incorrectly infer from the existence of a parent increased sophistication, financial security, and expertise on the franchisor's part.[310] We also recognize that where a parent sells franchises or provides products or services to a franchisee it would already fall within the proposed Rule's definition of "affiliate." Under the UFOC Guidelines and the proposed revised Rule, a parent-affiliate must disclose whether it operates franchises in the same or in other lines of business.[311] Accordingly, in such instances no additional, parent-specific disclosure is warranted.

Nonetheless, we believe the revised Rule should reference parents, consistent with current practice. We first note that affiliates in Item 1 would not include parents in all instances. For Item 1 purposes, "affiliate" is limited to those affiliates that sell franchises or provide services to franchisees only. As Dr. Vidulich observed, however, it is possible that a parent is a non-franchisor. A reference to parent, therefore, ensures that non-affiliate parents will be disclosed. Moreover, our proposal would require franchisors only to identify the existence of a non-affiliate parent: it would not require a franchisor to disclose such a parent's prior business history, in

---

[308] Vidulich, ANPR, 22Aug97 Tr, at 16-17. Similarly, a franchise system with a poor financial record or significant litigation could, for example, seek to shield itself from disclosure by establishing a new subsidiary that will offer identical franchises, but under a different trademark.

[309] PMR&W, Comment 4, at 9; H&H, Comment 9, at 15-16; J&G, Comment 32, at 9. The NPR proposed that "affiliate" for Item 1 purposes 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." 64 Fed Reg. at 57,334.

[310] *E.g.*, Triarc, Comment 6, at 3.

[311] *See* UFOC Guidelines, Item 1E Instructions; 64 Fed. Reg. at 57,334.

contrast to the Item 1 disclosures for affiliates and predecessors.[312] Accordingly, requiring a franchisor simply to identify its non-affiliate parent would impose at most a minor burden that is outweighed by the potential benefit to prospective franchisees.

b. Predecessor disclosures

In response to the NPR, no commenters questioned the basic principle that predecessor information should be disclosed.[313] However, two commenters, H&H and GPM, raised concerns about the parameters of the proposal, as stated in the NPR. H&H told us that the proposed disclosure period – 10 years – is too long, noting that Item 2 establishes only a five-year disclosure period for business experience of actual company managers. A shorter reporting period would provide an "ample period of time for a prospective franchisee to determine if a system has merely changed its name to escape bad press or a bad reputation." H&H, Comment 9, at 16. Further, a longer reporting period is likely to produce irrelevant information that is both costly and burdensome to prepare. In a similar vein, GPM would narrow proposed Item 1's focus to require the disclosure of information about only any immediate predecessor:

> In an era of constant mergers, consolidations, acquisitions, and other fundamental structural changes, it does not make sense to require franchisors to provide a 10-year predecessor history – or a detailed history of every officers' business dealings for that matter – which history will often have no bearing on the currently proposed sale.

GPM Rebuttal, Comment 40, at 4.

The staff rejects the view that predecessor disclosures should be limited to five years or to information about the franchisor's immediate predecessor. Franchisors that merge, consolidate, or otherwise restructure are likely to be sophisticated companies, well-represented by counsel. Most likely, these franchisors obtain background information on company predecessors as part of their due diligence review. We doubt, therefore, that requiring franchisors to supply 10 years of predecessor information would be unduly burdensome. Moreover, the benefit of preventing companies from merely changing their names to avoid damaging disclosures (e.g., prior litigation,

---

[312] If a parent qualifies as an affiliate under Item 1, however, then its information would be disclosed the same as all other affiliates.

[313] The disclosure of predecessor information will help to reduce fraud by ensuring that a franchisor cannot avoid disclosure obligations simply by assuming a new corporate identity. This is particularly a problem in the sale of business opportunities, where scam artists often change names repeatedly in order to avoid detection. *E.g.*, *FTC v. Wolf,* Bus. Franchise Guide (CCH) ¶ 10,401 (S.D. Fla. 1994). For example, in *FTC v. Inv. Dev., Inc.*, Bus. Franchise Guide (CCH) ¶ 9,326 (E.D. La. 1989), the staff obtained a series of orders to stop the defendants' fraudulent evolving scheme under various corporate names.

bankruptcies, or a significant number of failed franchisees) will likely outweigh any costs. At the very least, we are unconvinced that the burden of supplying 10 years of predecessor information is so great as to justify deviating from the UFOC Guidelines on this issue.[314]

c. Competition

Finally, Howard Bundy suggested that the Commission broaden Item 1 to require the disclosure of business dealings involving companies owned by company officers. According to Mr. Bundy, "sweetheart" deals involving companies owned by officers are "ripe for abuse":

> [D]o the officers' companies have the ability to compete with the franchisees? Are the officers' companies designated vendors? Keep in mind that a company owned by an officer and his spouse who are not majority shareholders of the franchisor probably is not within the definition of an "affiliate." Failing to close that informational gap will give the scam artists a good road map for taking unfair advantage of franchisees.

Bundy, Comment 18, at 6.

We agree, but perhaps for a different reason. A company officer's interests in outside entities may create a conflict of interest, influencing the franchisor's business, possibly against the interests of existing and prospective franchisees. Such conflicts of interest would go to the very heart of the relationship between the franchisor and franchisee, and therefore, are material and should be disclosed. Consistent with our view that the Commission should expand the Rule's disclosures to shed additional light on the nature of franchisor-franchisee relationships, we recommend that the Commission expand Item 1 to require the disclosure of "competition from any entity in which a company officer owns an interest."[315]

---

[314] Moreover, deviating from the UFOC Guidelines is unlikely to reduce the compliance burden because many franchisors will have to follow the UFOC Guidelines' 10-year provision in the registration states.

[315] For the same reasons, we also support a comparable disclosure for suppliers in which a company officer has an interest, but believe this issue is best addressed in section VI.J. concerning suppliers.

D. Proposed Section 436.5(b) Item 2: Business Experience

1. Background

The current Rule requires the disclosure of the business experience of the franchisor's directors and certain executives.[316] In the NPR, the Commission proposed adopting the comparable disclosure provisions found in UFOC Guidelines Item 2. However, as proposed in the NPR, Item 2 would differ from UFOC Item 2 in two respects. First, proposed Item 2 could cover "*de facto*" officers, namely individuals who in fact function as corporate officers, but who do not have an official corporate officer title. Second, proposed Item 2 would require the disclosure of the business experience of a parent's managers.

2. The record and recommendations

a. Parents and affiliates

In the NPR, the Commission proposed the following disclosure requirement: "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." 64 Fed. Reg. at 57, 334. The NPR's reference to the franchisor's parent generated several comments.

Warren Lewis asserted that, if adopted, this provision would:

> cause many franchisors and subfranchisors with parents to disclose information on all of their parents' directors, officers and similar executives, since all of those

---

[316] *See* 16 C.F.R. § 436.1(a)(2). In the SBP, the Commission explained that a franchisor's failure to disclose its business experience violates Section 5 because "it (1) misleads the prospective franchisees as to the business experience of the parties with whom they are dealing, and (2) could readily result in economic injury to franchisees due to their heavy dependence upon the experience of those persons associated with the franchisor." 43 Fed. Reg. at 59,642. *See* Buckley, ANPR 97, at 1 ("franchisor represented his company as highly trained in all phases of the business and capable of supporting a franchise system"); *FTC v. Nat'l Consulting Group, Inc.,* Bus. Franchise Guide (CCH) ¶ 11,335 (N.D. Ill. 1998) (claims regarding medical billing expertise and contacts with medical community are material); *FTC v. Levinger*, Bus. Franchise Guide (CCH) ¶ 10,438 (D. Ariz. 1994) (earnings claims tied to purported expertise in the restaurant industry are material); *Car Checkers of Am.*, Bus. Franchise Guide (CCH) ¶ 10,163 at 24043 (claims regarding car inspection business expertise are material). *Cf. FTC v. Goddard Rarities, Inc.,* No. CV93-4602-JMI (C.D. Cal. 1993) (representations of expertise in coin investments are material).

> persons at least arguably have management responsibility relating to the franchises offered by their companies' subsidiaries. This would clutter their Item 2s with information of marginal relevance and importance to prospective franchisees.

Lewis, Comment 15, at 12.

Similarly, BI contended that if a franchisor is truly distinct from its parent, then directors and officers, for example, will have minimal involvement with the franchise and, therefore, should not be listed. "In addition, their inclusion in the document blurs the line separating the franchisor and parent, arguably exposing the parent, unfairly, to liability arising from the franchise activity." BI, Comment 28, at 5.

H&H suggested that the Commission revise the first sentence of the NPR proposal, offering the follow language:

> Disclose the position and name of the directors, trustees, general partners, and officers of the franchisor and the subfranchisor [footnote], if applicable, who will have management responsibility relating to the offered franchisees. [Text of footnote: A franchisor need only provide disclosures with respect to the subfranchisor(s) that will provide services to the prospective franchisee. At the franchisor's discretion, it may include disclosures with respect to other subfranchisors, as well.]

H&H, Comment 9, at 16. The firm asserted that its suggested rephrasing would clarify that a franchisor need only disclose names and positions of all persons with management responsibility. It would avoid references to officers of any parent and avoid the need to include *de facto* officers in the definition of "officer," as originally proposed.[317] Further, the suggested language would:

> clarify [that f]ranchisors should only be required to furnish information about subfranchisors that will provide services to the prospective franchisees. For example, a prospective franchisee in the United States would not need to know about subfranchisors located in foreign countries. However, where a franchisor has multiple domestic subfranchisors and wants to create one UFOC for all prospective franchisees, it should be allowed to include information on all its domestic subfranchisors. [This would] reduce compliance costs by creating one comprehensive UFOC, rather than creating a different UFOC for each subfranchisor.

---

[317] *See* discussion of "officer" definition at section IV.R.2.c. above.

Id. at 17.[318]

Howard Bundy, in contrast, argued in favor of an expanded Item 2. He would add the phrase "or affiliates" after the word "parent" in Item 2. Mr. Bundy maintained that, without specific coverage of affiliates, "someone who wanted to hide a personal history that was less than exemplary could have that person separately employed as an officer of an affiliate and then cause the affiliate to perform the services for the company under contract." Bundy, Comment 18, at 6-7.

Based upon the comments, we recommend that the Commission modify Item 2's scope as follows. We agree with the commenters that franchisors, as a general proposition, need not disclose information about all parent officers. While in many instances a parent's officers may exercise general management responsibilities that affect the franchisor, they are not necessarily involved in managing the franchisor or its franchises. In such instances, their background information is unlikely to be material to a prospective franchisee. Accordingly, we recommend that the Commission delete the proposed reference to parents in Item 2.

At the same time, we believe a franchisor should identify all individuals who control the franchisor, regardless of any formal title. This is true even if the individual is an officer of a parent or an affiliate.[319] As long as the individual exercises control over the franchisor, then his or her background information should be disclosed, no less than officers of the franchisor itself. To that end, we recommend that the Commission require franchisors to disclose "the franchisor's directors, trustees, general partners, principal officers, and any other individuals who occupy a similar status or perform similar functions."

Consistent with the UFOC Guidelines, other executives and subfranchisors should be disclosed only if they exercise management responsibilities relating to franchising specifically. Nonetheless, we would modify the UFOC Item 2 language slightly. UFOC Item 2 limits the disclosure to those executives and subfranchisors who will have "management responsibility

---

[318] We also note that David Gurnick questioned the breadth of proposed Item 2. He observed that board members and officers – especially of large, publicly traded corporations – may change. He recommended that the Commission adopt a materiality standard so that franchisors need not update their UFOCs due to an addition or departure of board members or officers "that is rarely likely to be material to a prospective franchisee." Gurnick, Comment 21, at 3. We believe that the Rule's updating requirements address this issue sufficiently.

[319] *See U.S. v. Perfumes Unlimited,* No. 02-21767-CIV-Huck (S.D. Fla. 2002). We also believe there is merit in H&H's suggestion that franchisors be permitted to include, at their discretion, a list of subfranchisors on a national basis. However, the final revised Rule already contemplates that franchisors can aggregate information in their disclosure documents in order to have a single, multi-state document. *See* below at section VII. Therefore, no revision of Item 2 is necessary to address this issue.

relating to the franchises offered by this offering circular." This language is not entirely clear. The term "relating to the franchises offered" could mean relating to franchise sales activities, post-sale franchise operations, or both. We believe that the intent of the UFOC Guidelines was to cover both franchises sales and post-sale operations. We recommend, therefore, that the Commission use the phrase "management responsibility relating to the sale or operation of franchises offered by this document." So revised, the first part of proposed Item 2 would read as follows: "Disclose by name and position the franchisor's directors, trustees, general partners, principal officers, and any other individuals who occupy a similar status or perform similar functions. In addition, disclose other executives or subfranchisors who will have management responsibility relating to the sale or operation of franchises offered by this document."

b. Brokers

By adopting UFOC Guidelines Item 2, the NPR effectively incorporated the requirement that a franchisor "list all franchise brokers."[320] As noted in our discussion of the proposed "franchise seller" definition, a few commenters asserted that the Item 2 broker disclosures are unnecessary. For example, J&G questioned the inclusion of broker information in Item 2, stating that requiring "detailed information about every corporate employee of a broker . . . is extremely cumbersome and of little use to prospective franchisees." J&G, Comment 32, at 10.

We agree. The disclosure of broker information serves no real purpose under the Commission's pre-sale disclosure approach, and imposes unwarranted compliance costs. Item 2 requires the disclosure of the background of those individuals who control the franchisor, as well as those who actually manage franchisees. That information is material because prospective franchisees need to know with whom they will be dealing and whether such individuals are likely to perform as promised in the franchise agreement. However, brokers are not parties to the franchise agreement. Accordingly, prospective franchisees do not rely on brokers to perform under the agreement and, therefore, a broker's business background has little bearing on the likelihood of a franchisee's success. In practical terms, the disclosure of brokers would also be cumbersome, especially for large franchise systems that may employ hundreds of brokers nationally.[321] While we strongly favor adopting the UFOC Guidelines approach to the fullest extent possible, we believe that this is one area where an exception is warranted. The Item 2 broker disclosures are unnecessary and should be deleted from the final revised Rule.

---

[320] 64 Fed. Reg. at 57,334. Because brokers are listed in Item 2, their litigation and bankruptcy histories would also necessarily have to be disclosed in Items 3 and 4.

[321] Franchisors, of course, would still be able to include broker information, if required by state law.

E. Proposed Section 436.5(c) Item 3: Litigation

1. Background

Currently, the Franchise Rule requires franchisors to disclose certain litigation involving the franchisor and its officers, affiliates, and parents.[322] In the NPR, the Commission proposed expanding this disclosure in several material respects. Consistent with UFOC Guidelines Item 3, proposed Item 3 would require franchisors to disclose actions involving predecessors, as well as routine litigation that may impact upon the franchisor's financial condition or ability to operate the business.[323] At the same time, proposed Item 3 would differ from the UFOC Guidelines by retaining the current disclosure of actions involving parents. Most important, proposed Item 3 would expand both the Rule and UFOC Guidelines by requiring franchisors to disclose material franchisor-initiated litigation against franchisees involving the franchise relationship.

2. The record and recommendations

a. Parents, predecessors, and affiliates

As noted above, the NPR proposed retaining the disclosure of parent litigation on the grounds that it is necessary to prevent fraud.[324] In response, several franchisor representatives opposed the parent litigation disclosure. Their comments parallel the discussion of parent disclosures in Items 1-2 discussed above. For example, PMR&W maintained that the parent

---

[322] *See* 16 C.F.R. § 436.1(a)(4). In the SBP, the Commission stated that a franchisor's litigation history is material because it bears directly on the "integrity and financial standing of the franchisor." 43 Fed. Reg. at 59,649. *See, e.g.*, *FTC v. WhiteHead, Ltd.*, Bus. Franchise Guide (CCH) ¶ 10,062 (D. Conn. 1992) (full disclosure would have revealed a $10 million judgment in a fraud action brought by former franchisees); *Joseph Hayes,* No. 4:96CV02162SNL (E.D. Mo. 1996) (full disclosure would have revealed prior state fines and injunctions); *Inv. Dev., Inc.,* Bus. Franchise Guide (CCH) ¶ 9,326 (full disclosure would have revealed arson and insurance fraud convictions). *See also* Marks, ANPR, 19Sept97 Tr, at 8 ("I always counsel clients . . . to look at the litigation section among one of the first sections.").

[323] Under this provision, a fast-food restaurant franchisor, for example, would have to disclose a product liability class action suit that, if successful, might materially affect its financial condition or ability to maintain its business operations. 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 Fed. Reg. at 59,649.

[324] 64 Fed. Reg. at 57,303. *Cf. U.S. v. Jani-King Int'l, Inc.*, Bus. Franchise Guide (CCH) ¶ 10,711 (N.D. Tex. 1995) (franchisor disclosed only litigation of subfranchisor, not parent company).

litigation disclosure is confusing at best and offers little if any benefit to prospective franchisees. A publicly-traded parent may face any number of securities fraud claims, for example, that would have to be disclosed, "overflowing [the disclosure document] with largely irrelevant parent litigation summaries, obscuring and diverting readers from the more important disclosures of franchisor litigation, and greatly increasing compliance burdens and costs." PMR&W, Comment 4, at 9.[325]

PREA added that parent disclosures have merit where the franchisor has few assets or a prior history such that the prospect is looking to the parent for assurance of continued financial viability. It suggested that the Commission create an exemption from Item 3 for parent disclosures if the franchisor has sufficient net worth and experience. It proposed a net worth of not less than $5 million and a requirement that the franchisor has had at least 25 franchisees for each of the preceding five years.[326]

On the other hand, Seth Stadfeld urged the Commission to broaden Item 3's scope. He would require the disclosure of litigation involving all affiliates, not just those under the franchisor's principal trademark. "Frequently, franchisors set up corporate structures where affiliated companies deal with franchisees in the capacities of landlord, supplier, insurer, financier, and otherwise." Stadfeld, Comment 23, at 11.

After reviewing the record, the staff agrees that the NPR's coverage of parent and affiliate litigation should be revised. First, we are persuaded that litigation involving a parent (which may be sizeable in the case of a publicly-traded parent) may have little bearing on the operation of the franchise system itself. Yet, we do not recommend eliminating the disclosure completely. Rather, we would limit the parent litigation disclosure to those circumstances where the parent guarantees the franchisor's performance.[327] Where a parent induces franchise sales by promising to back the franchisor financially or otherwise guarantee performance, the parent's prior litigation history is material and should be disclosed.

At the same time, we recommend that the Commission broaden the types of affiliates about whom it is necessary to disclose litigation brought by governmental entities. As noted above, for Item 3 purposes, the UFOC Guidelines limit disclosures about litigation to affiliates offering franchises under the franchisor's principal trademark. We believe this is too narrow. Our concern is that a fraudulent franchisor system could continue to perpetuate a fraud by closing shop, moving, and establishing a new franchise system that uses a different mark.[328] For example,

---

[325] *See also* Triarc, Comment 6, at 2; NFC, Comment 12, at 28; PREA, Comment 20, at 1.

[326] PREA, Comment 20, at 1.

[327] *See* PREA, Comment 20, at 1.

[328] See discussion of parent, predecessors, and affiliates at 64 Fed. Reg. at 57,302.

a fraudulent system could go out of business, acquire a competitor, and then continue in business unabated under a different trade name. In such an instance, the franchisor would have no obligation to disclose its past, falling outside the definition of both predecessor and affiliate. On the other hand, we recognize that requiring franchisors to disclose all affiliate litigation would be too broad and burdensome, especially for large companies with multiple brands.

Accordingly, we propose the following solution. For purposes of pending and prior civil and criminal actions, we recommend that the Commission adopt the UFOC Guidelines approach, limiting affiliate disclosures to those selling franchises under the franchisor's principal trademark. This would compel the disclosure of prior history of fraud by the franchisor in most instances without overburdening franchisors or unnecessarily complicating the disclosure document for prospective franchisees.[329] However, for government actions delineated in Item 3, we would broaden affiliate coverage to include any affiliate who has offered or sold franchises in any line of business within the last 10 years. In our view, the strongest indicator of fraud and history of Rule violations is a government action for injunction (with or without a civil penalty or other redress).[330] Under this proposal, a franchisor with a history of fraud or Rule violations could not avoid government action disclosures merely by establishing a new corporation or switching trademarks. We believe this is a balanced approach that would result in the disclosure of material litigation history, without unduly burdening large, multi-brand franchise networks.

b. Prior civil litigation

In its comment, H&H noted that the NPR seemed to suggest that a franchisor must disclose all material civil litigation in which the defendant was *held liable* in the 10-year time period, but only the enumerated list of actions if *named* in civil litigation.[331] H&H suggested that

---

[329] We also note that Item 1 of the proposed revised Rule, like the current UFOC Guidelines, requires the disclosure of all affiliates offering any franchises or offering products or services to franchisees of the franchisor. Armed with such information, a prospective franchisee has the ability to discover broader affiliate litigation, if he or she so chooses.

[330] We note that there is no private right of action to enforce the Franchise Rule. *See, e.g., Holloway v. Bristol-Meyers Corp.,* 485 F.2d 986 (D.C. Cir. 1973) (no implied private right of action under the FTC Act); *Days Inn of Am. Franchising, Inc., v. Windham,* 699 F. upp. 1581 (N.D. Ga. 1988) (no private right of action exists to enforce the Franchise Rule).

[331] The enumerated actions include those alleging "a violation of a franchise, antitrust, or securities law, or alleging fraud, unfair or deceptive practices, or comparable allegations." *See* UFOC Item 3 at A.

the disclosure of civil litigation should be limited to the enumerated list regardless of whether the franchisor was named or was held liable in a prior suit.[332]

The staff agrees that the NPR's proposed litigation disclosure was overbroad and should be revised. H&H correctly observed that the NPR failed to limit the disclosure of prior civil actions in which the defendant was held liable to those suits involving the traditional enumerated list of classes, such as Franchise Rule violations and fraud.[333] So revised, proposed Item 3 would require the disclosure of actions where the defendant, within the 10-year period immediately before the disclosure document's issuance date, was held "liable in a civil action, or been a defendant in a material action" involving the enumerated list of actions.[334]

c. Settlements

Consistent with the UFOC Guidelines, the NPR proposed that franchisors disclose the terms of any settled actions, including confidential settlements.[335] The current Rule similarly requires the disclosure of settlements, but does not distinguish between confidential and non-confidential settlements.[336]

A few franchisors questioned this proposed disclosure. For example, PMR&W and Warren Lewis observed that there is no provision in the NPR proposal allowing for the omission of settled litigation where the settlement is favorable to the franchisor or otherwise neutral. Both

---

[332] H&H, Comment 9, at 17-18. *See also* NFC, Comment 12, at 28. H&H also questioned whether the term "ordinary routine litigation" will be defined in accordance with the current UFOC Guidelines and suggested that the word "material" be substituted for "significant." H&H, Comment 9, at 18.

[333] This does not mean that a franchisor can hide significant litigation that is not included in the enumerated list of actions. Consistent with the UFOC Guidelines, proposed Item 3 would require a franchisor to disclose "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."

[334] We also note that the NPR included a footnote that explained that franchisors need not disclose settlements which are favorable to the franchisor or are otherwise not materially adverse to the franchisor's interests, nor actions dismissed without liability or entry of an adverse order. 64 Fed. Reg. at 57,334 at n.2. To streamline the Rule, we recommend that this explanation be placed in the Compliance Guides.

[335] 64 Fed. Reg. at 57,334. *See also* NASAA Commentary, Item 3.

[336] 16 C.F.R. at § 436.1(a)(4)(ii).

commenters cited to the UFOC Guidelines[337] which state that "settlement of an action does not diminish its materiality if the franchisor agrees to pay material consideration or agrees to be bound by obligations which are materially adverse to its interests."[338] By implication, favorable or neutral settlements to a franchisor are not material and need not be disclosed.

Several franchisors also questioned the inclusion of confidential settlements. According to John Baer, it is unfair to require the disclosure of confidential settlement agreements "if they were entered into by a company at a time when it was not yet engaged in franchise activities." Baer, Comment 11, at 11. David Gurnick commented that the disclosure of any settlement terms that the parties agreed to keep confidential is bad policy. According to Mr. Gurnick, confidential settlements benefit both parties and the "opportunity for confidentiality is often an important dynamic to resolve a dispute." Gurnick, Comment 21, at 4.[339] He would permit the disclosure of material facts about confidential settlements in the aggregate, so that the franchisor could make the disclosure about a group of cases, without violating the confidentiality of any one or more cases. For example, a franchisor could state: "we have settled 10 cases with confidentiality agreements. In each of these cases, we made payments to the franchisee in the mid five figure range." *Id.*, at 5.[340]

Mr. Baer also questioned the disclosure of exact dollar amounts or other confidential settlement terms. "This often can expose the franchisor to the choice of not being able to register its franchise in a particular state or making a disclosure and possibly breaching the terms of the confidential settlement agreement." Baer, Comment 11, at 11. He suggested that the Commission allow franchisors to disclose approximate dollar amounts, such as "the low four figures, " or, in the alternative, a range of figures. *Id.*[341]

---

[337] UFOC Guidelines, Item 3 Definitions, iv.

[338] PMR&W, Comment 4, at 10; Lewis, Comment 15, at 13. Accordingly to Mr. Lewis, without such a limitation, the proposed Rule would penalize franchisors and subfranchisors who achieve favorable settlements, thereby discouraging settlement of litigation. *See also* Snap On, Comment 16, at 3.

[339] *See also* J&G, Comment 32, at 10-11; Marriott, Comment 35, at 15.

[340] *But see* Stadfeld, Comment 23, at 12 (urging the Commission to keep the UFOC requirement of disclosing specific payments in settlements regardless of confidentiality agreements).

[341] Mr. Baer also suggested that where a case has been settled by purchase or re-purchase of a franchised business and the amount does not exceed the fair market value of the business, a franchisor should be permitted to state: "The settlement included a purchase of the franchise . . . for an amount which, in our judgment, does not exceed its fair market value." *Id*., at 12.

The staff recommends that the Commission retain the proposed settlement disclosures, as modified below. First, we agree with Mr. Baer that it is unfair to compel a franchisor to disclose confidential settlements entered into before it began franchise sales. It is unreasonable to expect a non-franchisor to negotiate settlements with an eye toward the possibility that it may engage in franchise sales in the future. Accordingly, we recommend that the Commission limit the confidential settlement disclosure to those settlements entered into after commencing franchise sales activities. Second, Item 3 should permit franchisors to omit settled litigation where the settlement is favorable to the franchisor or otherwise neutral.[342] This is the clear intent of the UFOC Guidelines.

Third, we recommend that the Commission retain the disclosure of confidential settlements, but modify the disclosure requirement for those franchisors who have historically used the Franchise Rule's disclosure format. As a preliminary matter, we recognize that the disclosure of confidential settlement terms may be unpopular. However, this issue was debated when NASAA revised the UFOC Guidelines in 1993, with input from many interested parties. Recognizing that the disclosure requirements concerning confidential settlements might raise breach of contract issues, the NASAA Commentary on the UFOC Guidelines specifically limited the disclosure to those settlements that were entered into after the adoption of the UFOC Guideline revisions on April 25, 1993. Franchisors using the UFOC Guidelines format have been living under this policy on the state level for more than nine years, apparently without much hardship. Under the circumstances, we find no compelling reasons in the record to deviate from the UFOC Guidelines on this point.

At the same time, we recognize that some small or regional franchisors who use the Franchise Rule format have not had the opportunity to phase-in confidential settlement disclosures. Accordingly, we recommend that franchisors who have used the UFOC Guidelines format in the past continue to disclose confidential settlements, as is the current practice. However, franchisors historically using only the Franchise Rule format, as well as companies new to franchising, need not disclose confidential settlements entered into prior to the effective date of the revised Rule.

---

[342] For purposes of Item 3, the definition of "held liable" would mean 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." In other words, a franchisor need not disclose a settlement if the franchisor neither pays any material consideration, nor is bound by obligations that are materially adverse to its interests.

d. Franchisor-initiated litigation

In the ANPR, the Commission asked whether Item 3 should be expanded to require franchisors to disclose franchisor-initiated litigation.[343] Franchisees and their representatives,[344] as well as the Small Business Administration,[345] supported the proposal, asserting that franchisor-initiated litigation is material because it sheds light on: (1) the quality of the franchisor-franchisee relationship; and (2) the extent to which the franchisor may be litigious. Others added that franchisors currently must disclose franchisor-initiated litigation only if a franchisee files a counterclaim. Yet, franchisees often do not have the financial resources to initiate a suit or to pursue a counterclaim.[346] Therefore, the disclosure of franchise relationship litigation should not depend upon which party happens to have the resources to file a suit.

In contrast, franchisors generally asserted that franchisor-initiated litigation is immaterial.[347] To the extent that a franchisee is aggrieved by a franchisor-initiated suit, the franchisee, in their view, will surely file a counterclaim, which clearly must be disclosed under current law.[348] Further, in their view 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.[349] They voiced concern that disclosing such

---

[343] 62 Fed. Reg. at 9,116, 9,120-21.

[344] *See* AFA, ANPR 62, at 2; Lagarias, ANPR 125, at 3; Selden, ANPR 133, Attachment at 2; Karp, ANPR, 19Sept97 Tr, at 98.

[345] SBA, ANPR 36, at 5-6. *See also* IL AG, ANPR 77, at 2.

[346] Peter Lagarias observed 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, ANPR 125, at 3. *See also* Merret, ANPR 126; Brandt, ANPR 137; Doe, ANPR, 7Nov97 Tr, at 267.

[347] *E.g.,* Kaufmann, ANPR 33, at 4.

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

[349] *E.g.,* Kestenbaum, ANPR 40, at 1; Tifford, ANPR 78, at 3. *But see* Jeffers, ANPR 116, at 1-2 (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 aggressively eliminate continuing violations of its franchise agreement). As discussed below, we agree that litigation can be viewed as a positive attribute and its disclosure is consistent with pre-sale disclosure.

litigation would imply some wrongdoing by the franchisor.[350] Finally, they asserted that an expanded Item 3 would "bulk up" disclosure documents, thereby increasing compliance costs.[351] One franchisor representative, suggested that if the Commission were to require such a disclosure, it should consider establishing a threshold trigger: a franchisor would not have to make the disclosure unless it has sued at least a certain percentage (e.g., 5%) of the franchisees in its system.[352]

In the NPR, the Commission tentatively concluded that franchisor-initiated suits may reveal material information to a prospective franchisee.[353] For example, a pattern of franchisor-initiated lawsuits, such as royalty collection suits, may be highly material to a prospective franchisee because it is another source of information from which prospective franchisees can assess the risks in purchasing a franchise and the quality of the relationship with the franchisor. The Commission recognized, however, that the proposed Item 3 disclosure may increase compliance costs. Therefore, the Commission proposed limiting the franchisor-initiated litigation disclosure to pending, "material" franchisor-initiated law suits[354] involving the franchise relationship. Under this proposal, franchisors would disclose if they are:

> a party to any pending material civil action involving the franchise relationship. For purposes of this paragraph, "franchise relationship" means contractual obligations between the franchisor and franchisee directly relating to the operation of the franchisee business (*E.g.,* royalty payment and training obligations). It does not include suits involving third parties such as suppliers or indemnification for tort liability.[355]

---

[350] *E.g.,* Kaufmann, ANPR 33, at 4; Tifford, ANPR 78, at 3; Cendant, ANPR 140, at 3.

[351] *E.g.,* Baer, ANPR 25, at 3; Kaufmann, ANPR 33, at 4; Jeffers, ANPR 116, at 1-2; Forseth, ANPR, 18Sept97 Tr, at 20.

[352] Baer, ANPR 25, at 3.

[353] 64 Fed. Reg. at 57,303.

[354] *See* Quizno's, ANPR 16 (suggesting that the materiality standard should be maintained).

[355] *See* Cendant, ANPR 140, at 3 (noting 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; such suits, therefore, are really between the customer and the franchisor and are not indicative of franchise system performance).

64 Fed. Reg. at 57,334.[356]

Franchisee advocates and state regulators uniformly supported the expanded litigation disclosure for the reasons stated in the NPR: the disclosure of franchisor-initiated litigation would reveal material information about the quality of the franchise relationship, as well as the extent to which the franchisor is litigious. Typical of these comments is the one submitted by NFA, an association of Burger King franchisees, stating that the proposed disclosure:

> would be beneficial to potential franchisees, as it would allow such franchisees to be aware of any difficulties current or prior franchisees have encountered with the franchisor. In addition, the required disclosure of franchisor-initiated litigation would further aid potential franchisees by serving as an indicator of how franchisors resolve their disputes, and whether or not such franchisors are quick to resort to litigation in order to resolve disputes. The possibility of extensive litigation is important to a potential franchisee, as it may affect the calculation of costs involved in acquiring such a franchise. In addition, the continued threat of litigation from the franchisor may well affect later dealings between the parties, and as such is critical information of which the franchisee should be aware.

NFA, Comment 27, at 2.[357]

A few commenters also maintained that the proposed disclosure need not be cost-prohibitive. For example, Seth Stadfeld observed that "once the initial changes are made, all that must be done is to update the disclosed litigation annually or sooner if material changes take place." Stadfeld, Comment 23, at 11. The AFA was more blunt in its assessment:

> The Commission has a choice. It can save franchisors a few pennies on a slightly larger offering circular or save a franchisee from investing hundreds of thousands of dollars in a franchise that he/she might not have invested in if he/she would have known all of the franchisor-initiated lawsuits against its own franchisees.

---

[356] The NPR also explored whether the disclosure should be tied to a threshold number of suits, such as actions filed against 5% of system franchisees. 64 Fed. Reg. at 57,329.

[357] *See also* AFA, Comment 14, at 4; NASAA, Comment 17, at 4; Bundy, Comment 18, at 7; Stadfeld, Comment 23, at 11; Karp, Comment 24, at 19. *But see* NaturaLawn, Comment 26, at 1 (asserting that if the Commission wants to address whether a franchisor it litigious, then it should require litigation disclosures only when there have been three consecutive fiscal years of lawsuits, regardless of the number of such suits).

AFA, Comment 14, at 4.[358]

Several franchisee advocates, however, asserted that the proposed franchisor-initiated litigation disclosure does not go far enough. Specifically, Howard Bundy would eliminate the restriction limiting the disclosure to "pending" litigation. He would require the disclosure of all franchise relationship suits by the franchisor or an affiliate commenced during at least the last three years. "Just giving the 'pending' cases is like giving only one month of financial statements. It does not permit the prospect to see and evaluate trends and developments." Bundy, Comment 18, at 7.[359]

Seth Stadfeld would eliminate the materiality element altogether, requiring franchisors to disclose *all* of their initiated litigation. A materiality standard would enable a franchisor "to exercise discretion and not disclose matters that in all probability would interest prospective franchisees greatly." Stadfeld, Comment 23, at 13. Rather than limit the disclosure, he would permit the franchisor to explain its rationale for bringing the suits. *Id.* Mr. Stadfeld also would require the disclosure of all litigation involving the franchisor and its relationships with franchisees, not just those involving the franchise system being offered for sale:

> Just as the disclosures in Item 1 call for disclosure of information involving other franchise systems that the franchisor or its predecessors have been affiliated with so too, Item 3 should furnish prospects with information on material litigation involving any franchise system or business opportunity program the franchisor or its affiliates have been affiliated with.

Id. at 12.[360]

Finally, Eric Karp urged the Commission to broaden the proposed disclosure to include franchisor initiated litigation against third-party suppliers: "If a franchisor were to sue a supplier of goods or services it sells to franchisees, over issues relating to quality or efficiency of supply or to block sales not authorized by the franchisor, the prospective franchisee would have good reason to want to know about the claim." Karp, Comment 24, at 20.

Consistent with their ANPR comments, franchisors and their representatives uniformly opposed the disclosure of franchisor-initiated litigation. In fact, several commenters questioned the very purpose of the proposed expansion. For example, PMR&W asserted that Item 3 has a

---

[358] *See also* Karp, Comment 24, at 20 (disclosure costs pale in comparison with litigation costs).

[359] *See also* Stadfeld, Comment 23, at 13.

[360] Mr. Stadfeld would define "franchise relationship" as "contractual obligations between a franchisor and franchisee relating to a franchised business." Stadfeld, Comment 23, at 12.

limited intent, namely, to:

> inform the franchisee about proven or alleged franchisor actions which may reflect poorly on the franchisor; disclosure also is required for franchisor-initiated litigation where a defendant files a counterclaim containing specified claims. A franchisor's lawsuit against the franchisee, in the absence of a relevant counterclaim, does not reflect any adverse conduct by the franchisor.

PMR&W, Comment 4, at 10.[361]

Indeed, some franchisors argued that the disclosure could be misleading, wrongly implying that the franchisor has engaged in illegal or other misconduct. For example, Snap-On voiced concern that:

> When a franchisee reviews an Offering Circular litigation disclosure, it is unclear whether a franchisee will read all of the specific litigation summaries contained in the Offering Circular or is influenced merely by the number of entries made. They may not be focusing on whether or not the litigation is against the franchisor or is litigation that the franchisor has brought that does not involve a discloseable claim by a franchisee.

Snap-On, Comment 16, at 2.[362]

Similarly, H&H contended that there is little value in requiring franchisors to disclose garden variety litigation involving franchisees, such as debt collection actions.[363] In its view, the disclosure would mean nothing more than that the franchisor is enforcing its contract.[364] Worse, some franchisors feared that a mandatory franchisor-initiated litigation disclosure might actually discourage franchisors from bringing suits, even meritorious suits, that are needed to maintain the integrity of the franchise system. PMR&W, for example, asserted that the proposed disclosure

---

[361] *See also* H&H, Comment 9, at 17; J&G, Comment 32, at 10; Marriott, Comment 35, at 14. Several franchisors also agreed that a franchisor-initiated litigation disclosure is unnecessary because if there are problems in a system, the franchisee will surely file a counterclaim, which all agree must be disclosed. *E.g.*, Quizno's, Comment 1, at 1; PMR&W, Comment 4, at 9; Holmes, Comment 8, at 4.

[362] *See also, e.g.*, Gurnick, Comment 21, at 5; NaturaLawn, Comment 26, at 1; J&G, Comment 32, at 10; GPM Rebuttal, Comment 40, at 4-5.

[363] H&H, Comment 9, at 17. *See also* Quizno's, Comment 1, at 1; Gurnick, Comment 21, at 5.

[364] *See also* Quizno's, Comment 1, at 1.

> may . . . dissuade a franchisor from filing litigation to protect the system and its brand image. This inhibition is not only a result of the need to include a new disclosure; it also arises from the obligation to cease sales while the disclosure document is amended and, in some states, while the amendment filing is processed and reviewed.

PMR&W, Comment 4, at 9.[365]

Other franchisors asserted that the disclosure document already informs prospective franchisees about the state of the relationship. J&G, for example, contended that any material information about the franchise relationship can be determined from the Item 20 termination rates, as well as through the franchisor's financial statements.[366]

Further, several franchisors voiced concern about the relationship between the proposed franchisor-initiated litigation disclosure and state registration laws. Specifically, they opposed the disclosure because it might trigger burdensome state updating requirements. For example, Quizno's asserted that if the disclosure of franchisor-initiated litigation is deemed material by the Commission, it would also be deemed material by the states and, therefore, franchisors would have to stop selling in a state every time they filed a suit until they could amend their registrations.[367] Other franchisors suggested ways to limit the proposed disclosure, including requiring: (1) a threshold number of suits; (2) a threshold dollar amount; (3) limitations on franchisor counterclaims; and (4) greater use of summary data.

John Baer and others urged the Commission to consider limiting the disclosure to where this is a significant number of suits. Mr. Baer suggested a 5% threshold, under which a franchisor would not have to disclose its initiated litigation unless it has filed suit against at least 5% of the

---

[365] *See also* Snap-On, Comment 16, at 2; J&G, Comment 32, at 10; Marriott, Comment 35, at 14.

[366] J&G, Comment 32, at 10. *See also* GPM Rebuttal, Comment 40, at 4-5.

[367] Quizno's, Comment 1, at 1. *See also* Lewis, Comment 15, at 13 (franchisor would have to amend their disclosure documents); J&G, Comment 32, at 10 (would prevent sales in states that require sales to stop until amendments are filed and approved).

franchisees in its system.[368] Others suggested a higher percentage, such as 10%,[369] 15%,[370] or 20%,[371] while the IL AG suggested a lower percentage, such as 2%.[372]

The proposal to establish a threshold, however, did not garner universal support. Eric Karp, for example, stated: "The prospective franchisee should make his or her own determination as to whether the number of lawsuits is at a level that indicates a problematic franchise system." Karp, Comment 24, at 19-20. According to Howard Bundy, the imposition of a threshold number of cases before an obligation to disclose arises "invites abuse." Bundy, Comment 18, at 7.[373]

PMR&W suggested another alternative: the Commission should consider requiring a franchisor to disclose, on an annual basis, the number of litigation and arbitration proceedings it has pending against franchisees, along with a general summary of the types of claims involved.[374] In contrast, NASAA argued that a mere listing of number of suits "is insufficient to inform a prospective franchisee of this potentially material information." NASAA, Comment 17, at 4.

Wendy's suggested that the Commission limit the disclosure of franchisor-initiated litigation to "specifically enumerated types of claims which are significant to the entire franchised system," as well as a significant dollar amount. Wendy's, Comment 5, at 2. This would eliminate the burden of having to disclose small cases involving, for example, insignificant breaches of contract and indemnity suits. *Id.*[375]

---

[368] Baer, Comment 11, at 11. *See also* NFC, Comment 12, at 28; Lewis, Comment 15, at 13; BI, Comment 28, at 11; Tricon, Comment 34, at 6. NASAA stated that if the Commission were to limit the disclosure by imposing a threshold, it would support a 5% threshold. NASAA, Comment 17, at 4.

[369] NFC, Comment 12, at 28.

[370] Holmes, Comment 8, at 4.

[371] AFC, Comment 30, at 3.

[372] IL AG, Comment 3, at 6 (also recommending no threshold for smaller systems, such as those with fewer than 25 franchisees).

[373] Seth Stadfeld also argued that a threshold prerequisite would "discriminate[] arbitrarily in favor of large mature franchise systems to the detriment of small franchise systems." Stadfeld, Comment 23, at 13. Apparently, Mr. Stadfeld thinks that it is unfair to apply the same percentage threshold for large and small franchise systems because a uniform percentage would equal different numbers of actual suits that would trigger the disclosure.

[374] PMR&W, Comment 4, at 10. *See also* IL AG, Comment 3, at 2.

[375] *See also* Gurnick, Comment 21, at 5.

David Holmes would limit the proposed disclosure by eliminating counterclaims filed by a franchisor merely in response to a franchisee-initiated suit. In his view, this is appropriate if the Commission's concern is "with franchisors having a practice of suing their franchisees, not merely defending themselves." Holmes, Comment 8, at 4-5.

Finally, David Gurnick suggested that the Commission permit a franchisor to disclose a general description of the type of case, accompanied by a list of the case titles, case numbers, and status. This would eliminate duplicative information.[376]

For the following reasons, we recommend that the Commission retain the proposed franchisor-initiated litigation disclosure. Based upon the record, including comments from the AFA and other franchisee advocates, we are convinced that this information is material to prospects in order to assess the nature of disputes and the level of litigation within a franchise system. We recognize that Item 3, to date, may have focused narrowly on suits showing wrongdoing on a franchisor's part. We now believe that this should be broadened specifically to reveal more information about the state of the franchise relationship. For example, we agree with the commenters that franchisor suits to enforce system standards could be viewed as a positive attribute, showing that the franchisor is willing to maintain uniformity for the benefit of the entire system. A franchisor's willingness to protect its system is a material fact about the franchise relationship that should be disclosed to prospective franchisees.[377]

At the same time, we reject arguments to broaden the proposed franchisor-initiated litigation disclosure, as some have suggested. In order to minimize compliance burdens, we believe that the Commission should limit the disclosure to a "snap-shot" in time, sufficient to reveal the franchisor's practice of initiating litigation, as well as reveal the types of franchise relationship problems arising in the franchise system. A three-year period appears to be excessive for this purpose. Similarly, we agree that a "materiality" standard should apply. This is consistent with both the current Rule and UFOC Guidelines approach to litigation disclosures.[378] Indeed, immaterial information, by definition, is unlikely to influence a prospective franchisee's

---

[376] Gurnick, Comment 21, at 5.

[377] As noted throughout the rulemaking process, we find no basis to recommend that the Commission engage in a sweeping rulemaking that would dictate the substantive terms of franchise contracts. Nevertheless, we believe there is sufficient evidence in the record to support the proposition that information about the state of the relationship between a franchisor and its franchisees is material and, therefore, should be disclosed.

[378] 16 C.F.R. § 436.1(a)(4) (only material actions need be disclosed); UFOC Guidelines, Item 3 Definitions at iii ("Included in the definition of material is an action or an aggregate of actions if a reasonable prospective franchisee would consider it important in making a decision about the franchised business.").

investment decision, while imposing unwarranted costs and unnecessarily lengthening disclosure documents.

Further, there may be some merit to the argument that the franchisor should disclose all relationship litigation, including litigation involving the franchise being offered, litigation involving another franchise system owned by the franchisor, as well as litigation involving affiliates and third-party suppliers. We are not prepared to make such a recommendation, however. The core concern underlying the proposed franchisor-initiated litigation requirement is the status of the relationship between the franchisor and its franchisees, and the proposed disclosure is designed to address that issue. We must weigh the marginal benefit of expanding the litigation disclosure against the compliance costs and burdens, as well as legitimate concerns about bulking up a disclosure document beyond the point where a prospect would be inclined to read it. On balance, we do not believe further expansion of the litigation disclosure is warranted.

In reaching our recommendation to retain the franchisor-initiated litigation disclosure, we have also considered the various suggested alternatives that would reduce franchisors' compliance burdens. We do not adopt the suggestion that the Commission tie the disclosure to a threshold. We recognize that a bright-line threshold (such as the number or percentage of suits) might be useful, but we believe it is impossible, based upon the record, to fashion a "one size fits all" approach for every franchise system in all industries. Moreover, a threshold focuses on the quantity of suits and, therefore, would be most useful in determining litigiousness. However, application of a threshold might enable franchisors to avoid disclosing suits that shed light on the more pressing concern – the state of the relationship. When it comes to the state of the relationship, even a small number of suits initiated by a franchisor could be material to a prospective franchisee because they may reveal the nature of problems in the franchise relationship or show the franchisor's willingness to enforce system standards. As Eric Karp stated, the prospect can then determine for himself or herself whether the numbers revealed are significant.

Finally, we believe that Mr. Gurnick has raised some useful suggestions about the form of the disclosure that, if adopted, could reduce costs without greatly compromising the underlying purpose of the proposed disclosure. In order to streamline the Rule, we recommend that a franchisor report its litigation on an annual basis only.[379] Specifically, a franchisor would disclose all material litigation to which it was a party in the last fiscal year.[380] This approach, we believe, is clearer than the NPR's proposed "pending litigation" snap-shot. It also would have the additional benefit of reducing more frequent quarterly updating, which may be burdensome and

---

[379] *See also* Quizno's, Comment 1, at 2.

[380] This disclosure approach would also be more representative of franchisor-initiated litigation than pending litigation, which would weed out suits that may have been settled during the year, or which took less than a year to resolve.

perhaps impracticable in franchise registration states with more frequent updating requirements.[381] Further, we agree that a franchisor should be able to provide basic, summary information on its initiated litigation, without the need for long discussions on each and every case. Accordingly, we propose that "franchisors may list individual suits under one common heading, which will serve as the summary (for example, royalty collection suits)." The franchisor would then merely list each applicable suit (case name, court, file number), without the need to provide any additional explanation.

F. Proposed Section 436.5(d) Item 4: Bankruptcy

1. Background

As proposed in the NPR, Item 4 would extend the current Rule's bankruptcy disclosures.[382] Consistent with the UFOC Guidelines, the NPR proposed that Item 4 require franchisors to disclose bankruptcy information about predecessors and affiliates, to disclose foreign proceedings comparable to bankruptcy, and to make bankruptcy disclosures for 10 years, instead of the current seven years.[383] At the same time, Item 4 would retain the current Rule requirement that franchisors disclose their parent's bankruptcy history.[384]

2. The record and recommendations

A few commenters addressed the NPR proposal that franchisors disclose predecessor and parent bankruptcies. J&G, Marriott, and GPM asserted that the additional disclosure burden is not outweighed by any benefit to prospective franchisees.[385] Consistent with our previous discussions, we continue to believe that information about predecessors and parents is material and should be disclosed. Where a parent is in bankruptcy, for example, its assets include any franchisor-subsidiary. Under such circumstances, a prospective franchisee should be made aware

---

[381] States typically require immediate updating upon a material change.

[382] *See* 16 C.F.R. § 436.1(a)(5). In the SBP, the Commission found that bankruptcy information is material because it bears directly on the "integrity and managerial ability of the parties with whom [the franchisee] is dealing and . . . could readily result in drastic economic injury to the franchisee because it could lead him or her to invest substantial amounts of money in a bankrupt business." 43 Fed. Reg. at 59,650-51.

[383] 64 Fed. Reg. at 57,304.

[384] *Id.*

[385] J&G, Comment 32, at 11; Marriott, Comment 35, at 15; GPM Rebuttal, Comment 40, at 5.

that the franchisor in which it is considering investing might be sold, possibly to a competitor or to a company lacking prior franchise experience.

Several commenters also voiced concern about other aspects of proposed Item 4. First, David Gurnick suggested that the time period for reporting a bankruptcy should be reduced from 10 to five years. "Five years following a bankruptcy, an individual['s] or business's circumstances can dramatically change. A bankruptcy more than five years old is not a predictor of anything." Gurnick, Comment 21, at 6. Second, J&G raised another timing issue. As proposed, a franchisor would have to disclose a bankruptcy if certain events (such as discharge in bankruptcy) occurred within the last 10 years. J&G observed that this timing provision would compel the disclosure of a bankruptcy that was actually filed significantly earlier:

> [I]t would seem that ten years from the date of the filing of a petition would be the appropriate beginning date. We are aware of one case in which an officer was involved with a company when a petition was filed in 1986, and the bankruptcy proceeding is still pending. Were it settled this month (December 1999), disclosure of that event would be required for a total of 23 years!

J&G, Comment 32, at 11.

Third, Howard Bundy urged the Commission to expand the scope of the disclosure. As proposed in the NPR, Item 4 would require the disclosure of an affiliate's prior bankruptcy only if the affiliate currently offers franchises under the franchisor's trademark. Mr. Bundy would add the word "or has offered" after the word "offers." "Without this, so long as the affiliate does not *at the moment* offer franchises under the principal trademark, there would be no obligation to disclose a bankruptcy of the affiliate. . . . If the affiliate is involved, the affiliate should be required to disclose its bankruptcy." Bundy, Comment 18, at 7. Finally, NaturaLawn would exclude the disclosure of personal bankruptcies. The company noted that personal bankruptcies can be filed for a variety of reasons, such as divorces, medical issues, or insurance claims.[386]

We agree with Mr. Bundy that the disclosure of affiliate bankruptcies should be expanded. After revisiting this issue, it is clear that the UFOC Guidelines require franchisors to disclose the bankruptcy of any affiliate of the franchisor, not just those affiliates who offer franchises under the franchisor's principal mark. As previously noted, the definition of "affiliate" in the UFOC Guidelines varies for purposes of specific disclosure items. For example, "affiliate" for Item 3 (litigation) purposes is limited to "an affiliate offering franchises under the franchisor's principal trademark." UFOC Guidelines Item 3.[387] In the NPR, the Commission adopted similar language

---

[386] NaturaLawn, Comment 26, at 1.

[387] The more limited Item 3 definition of affiliate reduces franchisors' compliance burdens significantly. A franchisor may have numerous affiliates, any of which may have been involved in, or is currently involved in, material litigation. The disclosure of such affiliate information

for the Item 4 bankruptcy disclosure. However, in its comparison between the NPR and UFOC Guidelines, NASAA notes that the Item 4 Bankruptcy disclosure is not so limited.[388] In order to reduce inconsistencies between the Rule and the UFOC Guidelines, we recommend that the Commission use the general, broad definition of "affiliate" in Item 4 as well.[389]

We reject, however, other suggestions to modify proposed Item 4. We recognize that the 10-year reporting period may result in rare instances in the disclosure of a bankruptcy filed more than 10 years earlier. Nonetheless, we have to draw a line at some point, and we believe that the proposed 10-year reporting period is reasonable in order to give prospective franchisees a complete picture of the franchisor's bankruptcy history. We find no compelling reason to deviate from the UFOC Guidelines on this point. Similarly, we see no compelling reason to omit a personal bankruptcy. In many instances, franchisees entrust initial fees and ongoing funds to franchise managers for training and advertising, among other forms of assistance. The disclosure of a franchisor manager's bankruptcy would shed light on that manager's ability to safeguard and use those funds properly. Accordingly, we believe personal bankruptcies are material and should be disclosed.

G. Proposed Section 436.5(e) Item 5: Initial Fees

1. Background

In the NPR, the Commission proposed the following initial fee disclosure based upon Item 5 of the UFOC Guidelines:

---

arguably might impose significant compliance costs that may not outweigh any benefits to prospective franchisees. Therefore, the Item 3 litigation disclosure limited to affiliates offering franchises under the franchisor's principal trademark strikes the right balance between disclosure and costs. On the other hand, a franchisor and its affiliates presumably have few prior or current bankruptcies. Under the circumstances, a broader definition of affiliate in the Item 4 bankruptcy disclosure is not likely to impose unwarranted costs.

[388] NASAA Comparison, at 6. NASAA also noted one additional inconsistency between the UFOC Guidelines and the NPR: the UFOC Guidelines require a franchisor to state the material facts pertaining to a bankruptcy. *Id.* *See also* UFOC Guidelines, Item 4. We agree. Accordingly, we recommend that the Commission add this provision to the final revised Rule, consistent with the UFOC Guidelines.

[389] Consistent with Item 2, proposed revised Item 4 would also extend the UFOC Guidelines by requiring the bankruptcy disclosures not only for officers or general partners, but for any "other individual who occupies a similar status or performs similar functions." This is necessary to prevent franchisors from hiding prior bankruptcies of individuals who function as officers without a formal title.

(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 data and the factors that determined that amount. For purpose 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.

64 Fed. Reg. at 57,335.[390] This disclosure is substantially similar to the comparable Rule disclosure provision found at 16 C.F.R. § 436.1(a)(7).[391] Proposed Item 5, however, would extend the Rule's current disclosures by enabling franchisors to provide a range of fees, instead of a fixed fee.

2. The record and recommendations

The NPR's proposed Item 5 generated two technical comments. First, Warren Lewis focused on the use of the phrase "initial franchise fee." Recognizing that a prospective franchisee may pay more than just one fee in order to acquire a franchise, Mr. Lewis recommended that: (1) the title be changed from "Initial Franchise Fee" to "Initial Fees"; (2) "this fee is refundable" should be changed to "these fees are refundable"; and (3) "initial fee means" should be changed to "initial fees mean." Lewis, Comment 15, at 14. We agree.

Second, Howard Bundy correctly noted that the definition of "initial fee" in the NPR does not expressly include commitments to make payments to the franchisor. As drafted, proposed Item 5 defines an initial fee only in terms of cash actually paid. "It should include any amounts that the franchisee becomes obligated to pay before entering into the franchise. For example, if the entire initial franchise fee is deferred into a promissory note, that does not change the fact that it is an 'initial fee.'" Bundy, Comment 18, at 7.

---

[390] Pre-sale disclosure of cost information is prevalent in Commission trade regulation rules. *E.g.,* 900 Number Rule, 16 C.F.R. § 308.3(b) (requiring pre-sale disclosure of the cost of the call); Telemarketing Sales Rule, 16 C.F.R. § 310.3 (requiring pre-sale disclosure of the "total costs to purchase, receive, or use" the goods or services); Funeral Rule, 16 C.F.R. § 453.2 (requiring pre-sale disclosure of price information for funeral goods and services).

[391] In the SBP, the Commission recognized that the disclosure of complete and accurate information about the initial franchise fee is material. The failure to disclose such information pre-sale is deceptive because "it (1) misleads, or at least confuses prospective franchisees as to the amount of the required initial franchise investment and (2) could readily result in economic injury to a franchisee unable to fully obtain all such funds or unable to recoup the full amount of such funds in the course of the franchise business." 43 Fed. Reg. at 59,653.

We agree. The Item 5 "initial fees" disclosures are comparable to the required payment element in the definition of the term franchise. A "required payment" is not limited to cash, but includes commitments to make payments to the franchisor at a later date. If not, then a franchisor could seriously undercut the Item 5 cost disclosure by requiring prospects to sign notes or other obligations in lieu of immediate payment. Accordingly, Item 5 should include not just fees that are actually paid, but commitments to pay as well.

Mr. Bundy also urged the Commission to require the disclosure of any contractual formulas for determining the current initial fee:

> Historic fee ranges and factors may provide some information, but, particularly with a start-up franchisor, there is a tendency to reduce initial fees in the early stages to entice people to sign up. It is important to have that disclosed, and the proposed rule does it. However, it is equally or more important to have disclosure of any contractual formulas that will result in this prospect paying a different initial fee than the historic information would suggest.

Bundy 18, at 7.

Mr. Bundy is correct that proposed Item 5 would require franchisors to disclose how they calculated initial fees over the last fiscal year, but would not require franchisors to disclose the specific formula used to calculate an individual prospective franchisee's current initial fees. It is also true that in some instances the historical calculations may not be consistent with those set forth in the franchisor's current contract. Nonetheless, we believe that there is not a record of abuse sufficient to deviate from the UFOC Guidelines on this point. As long as the prospect is aware of the amount to be paid before the sale, how the franchisor derives that amount is not necessarily material. On the other hand, it is highly material for a prospective franchisee to know whether fees are uniform, because if they are not, the prospect may be able to bargain for a lower rate. Under the circumstances, the prospect should receive some historical information with which to gauge the parameters of the franchisor's willingness to negotiate fee changes. We believe that the historical overview required by proposed Item 5 is sufficient to accomplish that goal.

Finally, three commenters voiced concern about negotiated prices. The NFC, for example, asserted that the NPR implies that a franchisee can seek to negotiate initial fees only if the franchisor already disclosed in its Item 5 a range of previously accepted fees. Such a result would restrict prospective franchisees' ability to initiate fee negotiations:

> [I]t frequently makes sense for the franchisor to offer reduced initial and/or ongoing fees to the prospective franchisee. And, naturally, such an arrangement would be highly desirable to that prospective franchisee. Accordingly, the FTC should support this marketplace practice and make clear in its forthcoming commentary to the revised FTC Franchise Rule that such negotiations are, in fact, permissible and not in violation of the Rule (provided that following such a

negotiated transaction, the subject franchisor discloses that from time to time it discounts the initial and/or ongoing fees and under what circumstances it may do so).

NFC, Comment 12, at 10-11.

David Gurnick also suggested that the Rule permit a franchisor to disclose whether or not it will negotiate fees, and if it does so, permit disclosure of the conditions that may affect the negotiation.[392] BI would permit franchisors to disclose that it may lower the initial fees. However, the firm contended that where the initial fee is determined through negotiation, as opposed to the result of a formula or fixed calculation, the franchisor need not disclose the range of such negotiated initial franchise fees in the prior fiscal year.[393]

As an initial matter, we recognize that the Rule could be interpreted as prohibiting contract negotiations because the final terms and conditions agreed upon would not be reflected in the franchisor's disclosure document. We believe this is absurd. The Commission has every interest in ensuring the parties' ability to negotiate terms and conditions, including fees and other costs. We would be hard-pressed to conclude that a prospective franchisee did not get full disclosure when that very prospect engaged in the negotiation process. We therefore recommend that the Commission make clear in the Compliance Guides that a franchisor may negotiate fees without violating the Rule.

At the same time, we believe that Item 5, consistent with UFOC Item 5, should require franchisors to state a range of fees accepted in the previous fiscal year. The UFOC Guidelines do not distinguish between ranges of fees based upon contractual formulas, on the one hand, and negotiations on the other. Providing a range of fees, regardless of how or why these ranges came about, is useful information in the negotiation process. Such disclosure compels neither party to reach agreement on unacceptable terms: franchisors and prospective franchisees remain free to negotiation in and outside of any disclosed range. Accordingly, we see no reason to deviate from the UFOC Item 5 approach in this regard. Therefore, we recommend that the Commission adopt a revise Item 5 as follows:[394]

---

[392] Gurnick, Comment 21, at 6.

[393] BI, Comment 28, at 6.

[394] Proposed revised Item 5 would also clarify the NPR proposal in two additional ways. First, it would make clear that the definition of "initial fees" includes payments or commitments to pay an affiliate of the franchisor. This is consistent with the NASAA Commentary. *See also* NASAA Comparison, at 7. Further, the NPR failed to include the UFOC Guidelines provision that franchisors must disclose installment payment terms in either Item 5 or in Item 10. NASAA Comparison, at 7.

(e) Item 5: Initial Fees.

Disclose the initial fees and any conditions under which these fees are refundable. If the initial fees are not uniform, disclose the range or formula used to calculate the initial fees paid in the fiscal year before the issuance date and the factors that determined the amount. For this section, "initial fees" means all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens, whether payable in lump sum or installments. Disclose installment payment terms in this subsection or in [Item 10] of this section.

H. Proposed Section 436.5(f) Item 6: Other Fees

1. Background

In the NPR, the Commission proposed that franchisors disclose in Item 6 recurring or occasional fees associated with operating a franchise (e.g., royalties, advertising fees, and transfer fees).[395] This disclosure is substantially similar to the comparable Rule disclosure provisions currently found at 16 C.F.R. § 436.1(a)(8). It is also consistent with many Commission trade regulation rules that require sellers to disclose post-sale costs and conditions that will ultimately affect the total costs incurred in using a product or service.[396]

Consistent with the UFOC Guidelines, the NPR's proposed Item 6 would also extend the current Rule by adding a disclosure about the existence of advertising and purchasing cooperatives from which franchisees may be required to purchase services or goods. The franchisor would also disclose the voting power of any franchisor-owned outlets in the cooperative and, if company store voting power is controlling, the range of required fees charged

---

[395] 64 Fed. Reg. at 57,335. This disclosure recognizes that a prospective franchisee's investment is not limited to the initial franchise fee alone. Rather, a franchisee may incur considerable costs in the operation of the business, which will significantly impact upon his or her ability to continue operations and ultimately be successful. In the SBP, the Commission noted that the failure to disclose continuing costs violates Section 5 because it "(1) misleads or at least confuses the franchisee as to the required amount of his or her total investment; and (2) could readily result in economic injury to the franchisee unable to meet such continuing obligations." 43 Fed. Reg. at 59,654-55.

[396] *E.g.,* Telemarketing Sales Rule, 16 C.F.R. § 310.3 (requiring disclosure of the total costs, material restrictions, limitations, or conditions to purchase, receive, or use goods or services); Appliance Labeling Rule, 16 C.F.R. § 305.1(a) (requiring disclosures of yearly energy use); 900 Number Rule, 16 C.F.R. § 308.3 (requiring disclosure of any other fees that will be charged for the service).

by the cooperative. These additional disclosures would better enable prospective franchisees to understand restrictions on their independence, as well as the total costs of conducting business.

2. The record and recommendations

In response to the NPR, Warren Lewis and NASAA raised a technical issue. As drafted, Item 6 is titled "Recurring or Occasional Fees." They suggested that the Commission use the term "Other Fees" in the title and throughout the disclosure.[397] We agree. We also recommend that the Commission adopt two UFOC Guidelines policies that were missing from the NPR proposal: (1) that franchisors state explicitly whether any fees are non-refundable (rather than just stating the conditions when a fee is refundable);[398] and (2) that franchisors disclose whether continuing fees currently being charged are uniformly imposed.[399]

Further, the NPR proposed that franchisors be required to disclose 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." 64 Fed. Reg. at 57,335. This proposal is consistent with the current Rule, which requires the disclosure of third-party payments only to the extent the franchisor imposes or collects them for the third party. NASAA and Howard Bundy raised concerns about direct payments to third parties.

NASAA urged the Commission to expand Item 6 to include not only other fees paid to the franchisor (or to affiliates), but required payments made directly to third parties:

> The FTC should consider closing a gap in the UFOC Guidelines by requiring disclosure of required fees paid directly to third parties, *e.g.*, local advertising requirements, yellow page advertising expenses, costs of attending training and conventions, fees for obtaining audited financial statements and mandatory store updates and remodeling. These fees are not required to be disclosed in UFOC Item 6 and may reflect a material ongoing expense for franchisees.

NASAA, Comment 17, at 4. In the same vein, Howard Bundy added that in the "vast majority of the franchise cases we see, the franchisee's ongoing legal obligations to third parties far exceed the franchisee's ongoing legal obligations to the franchisor. However, the franchisee cannot obtain the franchise without incurring the third-party obligations." Bundy, Comment 18, at 8.[400]

---

[397] Lewis, Comment 15, at 14; NASAA, Comment 17, at 4.

[398] *See* NASAA Comparison at 8; UFOC Guidelines, Item 6, Instructions vi.

[399] *See* NASAA Comparison at 8.

[400] Mr. Bundy also suggested that franchisees need to understand that third-party obligations continue even if the franchise is terminated. *Id.* We agree, but believe that this raises a

We find merit in the arguments raised by NASAA and Mr. Bundy. The Commission has long held that a prospective franchisee should have a sound understanding of all financial commitments before he or she decides to purchase a franchise.[401] Nonetheless, we have several concerns about expanding Item 6 to include direct third-party payments.

As noted above, under the current UFOC Guidelines approach, a franchisor must disclose only those payments it imposes and collects directly or indirectly from third parties. Presumably, under such circumstances, the franchisor is aware of the amount of these fees at the time of the sale. A franchisor, however, may be unaware of the extent of payments made directly to third parties. For example, a franchisor might require a prospective franchisee to obtain insurance or Internet service, the cost for which may vary widely depending upon which carrier the franchisee selects. Similarly, a franchisor may require store updating and remodeling, even mandating certain specifications. Yet, remodeling costs may vary depending upon the contractor the franchisee selects and local construction material and labor costs.

In short, we believe that it is unreasonable to expect a franchisor to be able to disclose completely and accurately in all instances fees paid directly to third parties. Rather, we believe a more limited approach is warranted. We recommend that a franchisor list all required payments made directly to third parties and then state either the amount of the fee or that "the amount of the fee is unknown and may vary depending upon factors, such as the third-party supplier selected."

I. Proposed Section 436.5(g) Item 7: Estimated Initial Investment

1. Background

Proposed Item 7 of the NPR would require franchisors to disclose additional expenses necessary to commence business (e.g., rent, equipment, and inventory) in an easy-to-read table. It would also require franchisors to disclose any refund conditions.[402] Comparable cost disclosures are currently found at 16 C.F.R. § 436.1(a)(7).[403]

---

consumer education issue, not a pre-sale disclosure one, that is best handled by prospective franchisees' advisors and through Commission and industry educational efforts.

[401] *E.g.,* SPB, 43 Fed. Reg. at 59,653.

[402] 64 Fed. Reg. at 57,335-36.

[403] "Since . . . fees frequently involve substantial sums of money, it must be assumed that if they were fully disclosed, they would play a significant role in a prospective franchisee's decision of whether to enter into a franchise relationship." SBP, 43 Fed. Reg. at 59,652. The "[f]ailure to disclose material information as to the true cost of the franchise" is an unfair and deceptive trade

Proposed Item 7, however, would extend the current Rule provision by requiring a franchisor to disclose required payments made not just to the franchisor and its affiliates, but also to some third parties. It would also require franchisors to disclose additional expenses or funds[404] needed before operations begin and during the initial phase of the franchise.[405] The Commission suggested that this disclosure would essentially require franchisors to disclose the working capital a franchisee needs to start operations, as well as a break-even point. Specifically, the Commission stated that franchisors must:

> 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. . . . Franchisor 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.

64 Fed. Reg. at 57,305.

2. The record and recommendations

Several commenters opposed the NPR's references to "working capital" and "break-even" point.[406] In their view, this NPR proposal is inconsistent with the UFOC Guidelines and would inappropriately mandate a financial performance disclosure. For example, David Holmes asserted that:

> What's critical to understand is that it is impossible to provide a meaningful estimate of working capital requirements without making assumptions as to total revenues (and related costs), which is functionally equivalent to a representation as to financial performance. . . . [S]uch a representation is otherwise forbidden

---

practice in violation of Section 5. *Id.* at 59,653.

[404] The NPR used the terms "additional expense" and "other payments," 64 Fed. Reg. at 57,335, while the Commission's explanation of Item 7 referred to "additional funds." *Id.* at 57,304. We believe the term "additional funds" should be used, consistent with the UFOC Guidelines. *See* UFOC Guidelines, Item 7.E and Sample Answer 7.

[405] The UFOC Guidelines define the term "initial phase" to mean at least three months or a reasonable period for the industry. UFOC Item 7, Instructions, ii.

[406] *See*, *e.g.,* Lewis, Comment 15, at 14-15; Snap-On, Comment 16, at 3.

> unless made in accordance with Item 19. . . . [A] "disclosure" of working capital requirements is, from an intellectual standpoint, a "back door" method of providing representations as to financial performance.

Holmes, Comment 8, at 6. Mr. Holmes went so far as to suggest that the Commission expressly ban the disclosure of an estimate of working capital or other funds needed "during the initial phase" unless there has been related compliance with Item 19. *Id*. PMR&W echoed David Holmes' concerns and raised an additional issue: the term "initial phase" in the NPR is undefined. PMR&W observed that the Commission should expressly incorporate into Item 7 the UFOC Guidelines standard that a three-month initial phase is reasonable.[407]

After reviewing the record, we agree that the NPR was unnecessarily inconsistent with the UFOC Guidelines. The NPR would have required franchisors to disclose all expenses for the entire initial period. Under UFOC Item 7, however, franchisors must disclose only start-up expenses needed to open the business: the only instance in which franchisors must disclose required expenses for the initial period (defined as three months or other reasonable period in the industry) is in the Item 7 "additional funds" category.

Therefore, we recommend that the Item 7 chart be renamed: "Your Estimated Initial Investment." Similarly, we recommend that the Commission make clear that only the "additional funds" category must list expenses for the initial period and that "a reasonable initial period" should be at least three months or some other reasonable period for the industry.[408] More important, we further agree that references to a break-even point should be deleted. The UFOC Guidelines do not require any disclosure of a break-even point, and a mandatory break-even disclosure would essentially force many franchisors to make a financial performance claim, contrary to the voluntary approach of Item 19.

Finally, PMR&W asserted that the additional funds category is too broad. Citing the NASAA Commentary, the firm notes that owners' salary, for example, should be excluded.[409] We believe this issue is best addressed in a Compliance Guides, where the Commission can explain the term "additional funds" in greater detail. Specifically, we recommend that the Compliance Guide adopt the NASAA Commentary's view that franchisors may exclude franchisee-owner's salary from the additional funds list. The Compliance Guide should also

---

[407] PMR&W, Comment 4, at 10-11. *But see* J&G, Comment 32, at 11 ("We applaud the addition of the language which defines 'initial phase' as 'your estimated investment for the first ___ months.' This provides clarity for franchisors and prospective franchisees.").

[408] We recommend that the Commission also make clear in the Compliance Guides that a franchisor seeking to apply an initial phase other than three months has the burden of showing the reasonableness of the phase selected.

[409] PMR&W, Comment 4, at 10-11.

state the Commission's intent that franchisors have flexibility in listing expenses in order to present a complete and accurate picture, while avoiding the making of financial performance representations, which, if made at all, must be included in Item 19.

J. Proposed Section 436.5(h) Item 8: Restrictions on Sources of Products and Services

1. Background

The Franchise Rule currently requires franchisors to disclose obligatory purchases, restrictions on sources of products and services, and the amount of any rebates the franchisor may receive from required suppliers.[410] In the NPR, the Commission proposed to adopt the more comprehensive disclosures found in Item 8 of the UFOC Guidelines.[411] Specifically, proposed Item 8 would extend the current Rule by requiring franchisors to disclose the criteria for evaluating, approving, or disapproving of alternative suppliers. In addition, franchisors must state whether, by contract or practice, the franchisor provides material benefits to franchisees who use designated or approved suppliers (e.g., renewals or additional outlets). It also would require franchisors to disclose the existence of purchasing or distribution cooperatives, and whether the franchisor negotiates purchase agreements with suppliers on behalf of franchisees.[412] These additional disclosures will enable the prospective franchisee to assess their likely costs and benefits, as well as their independence from the franchisor.

2. The record and recommendations

During the ANPR proceeding, several franchisees voiced concern about source restrictions that prevent them from obtaining supplies at cheaper rates.[413] These commenters generally did not allege that franchisors fail to disclose source restrictions, but complained about the "abusive nature" of such restrictions. For example, Jeff Brickner stated:

---

[410] *See* 16 C.F.R. §§ 436.1(a)(9)-(11). In the SBP, the Commission noted that buying restrictions are common in franchise agreements and are material because they will "have a significant impact on the sources of supplies and prices which a franchisee will pay for his or her supplies and thus also on the profitability of the franchise." 43 Fed. Reg. at 59,655. Similarly, required purchases "limit the independence of the franchisee, affect the profitability of the franchisee, and constitute a potential source of hidden profit for the franchisor." *Id.* at 59,656-67.

[411] 64 Fed. Reg. at 57,336.

[412] *Id.*

[413] *E.g.,* Manuszak, ANPR 13; Weaver, ANPR 17; Mueller, ANPR 29; Colenda, ANPR 71; Gagliati, ANPR 72; Buckley, ANPR 97; Haines, ANPR 100; Myklebust, ANPR 101; Rafizadeh, ANPR, 7Nov97, at 288-89; Slimak, ANPR, 22Aug97 Tr, at 26. *See also* Kezios, ANPR 64.

> [I]t seems like once a lot of franchise companies get a lot of units open, they decide that they have a captive audience and they limit the suppliers who you can purchase from. Generally, all the way to being able to purchase only from their distribution center. And then they put you at 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.

Brickner, ANPR 128.[414]

In addition, two franchisee advocates questioned the sufficiency of the UFOC Guidelines' Item 8. Andrew Selden urged the Commission to adopt and 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." Selden, ANPR 133, Appendix B, at 1. Mr. Selden, however, offered no specific language for the Commission's consideration. Robert Zarco, however, urged the Commission to require franchisors to include the following caution in their Item 8 disclosure:

> The company retains the right to approve all outside vendors supplying products to the franchisees. Our criteria generally focus on quality and concept-uniformity, but we reserve the right to modify the criteria for approving suppliers at any time. Additionally, there are no time limitations as to how long the review/approval of franchisee-endorsed vendors may take.

Zarco & Pardo, ANPR 134, at 2.

In the NPR, the Commission agreed that full disclosure of source restrictions and purchasing obligations is warranted. To that end, it proposed adopting the broader UFOC Guidelines' Item 8 disclosures.[415] The Commission found that proposed Item 8 "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." 64 Fed. Reg. at 57,305.

The NPR generated only a few comments. First, PMR&W and the NFC voiced concern about the proposed requirement that franchisors disclose the criteria for evaluating, approving, or disapproving of alternative suppliers. The NFC, for example, stated that the UFOC Guidelines

---

[414] Mr. Brickner added that he also must purchase specific equipment from only one manufacturer and the franchisor is the only supplier. *Id. See also* Buckley, ANPR 97 at 3; Myklebust, ANPR 101. A few franchisees reported that their franchisor failed to approve alternative suppliers or made it difficult for franchisees to find alternative sources of supplies. *E.g.,* Chiodo, ANPR, 21Nov97 Tr, at 308; Hockert-Lotz, *id.*, at 325-27.

[415] 64 Fed. Reg. at 57,305.

require only that franchisors disclose whether the franchisor's criteria for supplier approval are available to franchisees. It asserted that a franchisor's specific approval criteria is proprietary information. Rather, a franchisor should have to disclose only a general description of its selection criteria.[416] The staff agrees that the NPR is unnecessarily inconsistent with the UFOC Guidelines. Under the UFOC approach, a franchisor need only disclose the general process for approving or disapproving alternative suppliers, but not the exact selection criteria themselves. We recommend, therefore, that the Commission revise the proposed Rule to conform with the UFOC Guidelines.[417]

A few franchisee advocates maintained that the proposed NPR disclosure does not go far enough. According to the AFA, it is insufficient to require a franchisor to disclose whether a franchisee can purchase products from suppliers not affiliated with the franchisor:

> Full and complete disclosure requires franchisees be told what really happens when they bring a product/item to be approved under the franchisor's approval process. The following examples should be disclosed to the prospective franchisee in Item 8: "We have been known to take up to one year or more to approve a non-franchisor-affiliated vendor;" or "We have been known to change the specifications for [specific product] during the approval process. This has caused delays of between [number of days/weeks/months/years] to [number of days/weeks/months/years]."

AFA, Comment 14, at 4.

Howard Bundy also suggested that franchisors should disclose the dollar amount of any rebates received during some stated period, such as during the last year. The current UFOC approach, adopted in the NPR, requires franchisors to disclose only the percentage of revenue derived from such rebates. Words such as "'only 1%' may not alert the prospect to the reality that it amounts to hundreds of thousands of dollars over a year of individual small transactions." Bundy, Comment 18, at 8.[418] Mr. Bundy also urged the Commission to require franchisors to disclose whether participation in cooperatives is mandatory and the terms of such mandatory

---

[416] NFC, Comment 12, at 29. *See also* PMR&W, Comment 4, at 11.

[417] At the same time, we recommend one change in the UFOC Guidelines approach. As noted above in our discussion of Item 1, we believe the franchisor should disclose any supplier in which a franchisor's officer owns an interest. This information is material because it alerts the prospective franchisee to any potential conflict of interest on the franchise officer's part.

[418] Similarly, Harold Brown, a franchisee advocate, urged the Commission to prohibit direct and indirect "kick-backs" from third-party vendors to the franchisor. Brown, ANPR 4, at 3. The staff believes that proposed section 436.5(h)(5), requiring the disclosure of revenue to the franchisor from franchisee purchases, is sufficient to address this issue.

participation. "Otherwise, it is possible to structure a cooperative so that the franchisor or one of its officers has effective control and can use the cooperatives to extract extra money from the franchisee that no one disclosed." *Id.* at 8-9.

We find some merit in the observations of these franchisee advocates. Nonetheless we reject their suggestions that proposed Item 8 be expanded. In keeping with our goal of minimizing federal and state differences, we do not believe these suggestions are so compelling as to warrant deviating from UFOC Guidelines.

K. Proposed Section 436.5(i) Item 9: Franchisee's Obligations

1. Background

In the NPR, the Commission proposed adopting UFOC Item 9.[419] This disclosure gives prospective franchisees an easy-to-understand guide to 25 enumerated contractual obligations that are common in franchise relationships, with references to the sections of the franchise agreement and disclosure document that discuss each obligation in greater detail. There is no counterpart in the current Rule.

2. The record and recommendations

Proposed Item 9 generated only a few comments. Gary Duvall maintained that the disclosure is unnecessary. He would permit a franchisor to opt out of Item 9 if it provides prospective franchisees with a detailed table of contents or index to their franchise agreement.[420] On the other hand, Seth Stadfeld asserted that the disclosure does not go far enough: "As currently structured, this disclosure is not worth the time and effort largely because it provides no benefit to the prospect." Stadfeld, Comment 23, at 14. He suggested that franchisors use a remarks column to describe briefly the nature of each obligation. *Id.* Finally, J&G suggested that the Item 9 disclosures should apply only to franchise agreements, but not to any accompanying "licenses, leases, subleases, guarantees, security agreement, load documents, software agreements, etc." J&G, Comment 32, at 11. According to J&G, references to these ancillary agreements are burdensome and of little value to prospective franchisees.[421]

The staff recommends that the Commission adopt UFOC Item 9 in its entirety, as set forth in the NPR. We believe that Item 9 serves a useful purpose. Franchisee complaints submitted during the Rule amendment process tended to support the need for better pre-sale

---

[419] 64 Fed. Reg. at 57,305-06.

[420] Duvall, ANPR 19, at 2.

[421] *Id.*

disclosure about franchisees' legal obligations and the nature of the franchise relationship. Proposed Item 9 is essentially a detailed table of contents to the franchise agreement, with the additional benefit of cross references to the relevant sections of the disclosure document. It can increase the likelihood that a prospective franchisee will actually find and review the contractual provisions detailing their legal obligations, better ensuring that prospective franchisees understand fully the nature of the franchise relationship. Further, proposed Item 9 is entirely consistent with other trade regulation rules where the Commission has recognized that information about legal risks to consumers is material.[422] Moreover, many franchisors already use the UFOC Guidelines and prepare an Item 9 table. In addition, Item 9 should impose few costs or compliance burdens because franchisors need only reference existing materials, most likely the franchise agreement and disclosure document. To the extent that legal obligations are spelled out in any ancillary agreements, it is reasonable for franchisors to direct prospects to those provisions as well.[423]

L. Proposed Section 436.5(j) Item 10: Financing

1. Background

Consistent with Item 10 of the UFOC Guidelines, NPR Item 10 would require a 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.[424] This disclosure is similar to the comparable Rule disclosure provisions found at 16 C.F.R. § 436.1(a)(12).[425] For the most part, proposed Item 10 is comparable to the disclosures lenders

---

[422] *E.g.,* 900 Number Rule, 16 C.F.R. § 308.7 (obligations concerning billing disputes); Negative Option Rule, 16 C.F.R. § 425.1(a)(ii) (minimum purchase obligations); Door-to-Door Sales Rule, 16 C.F.R. § 429.1 (obligations regarding cancellations); Warranty Disclosures, 16 C.F.R. § 701.3(a)(5) (obligations to obtain performance).

[423] The UFOC Guidelines clearly contemplate that franchisors should reference other ancillary agreements, where appropriate. For example, the beginning of UFOC Item 9 reads: "Disclose the principal obligations of the franchisee under the franchise and other agreements after the signing of these agreements." The express reference to "other agreements" and the use of the words "these agreements," clearly indicates that the drafters directed franchisors to reference all applicable agreements. We see no compelling reason to deviate from the UFOC Guidelines in this instance.

[424] *See* 64 Fed. Reg. at 57,306.

[425] In the SBP, the Commission found that a prospective franchisee's ability to obtain sufficient funding on reasonable terms is a critical element in determining whether to enter into a

must make under the Federal Reserve's Regulation M (Consumer Leasing),[426] and Regulation Z (Truth in Lending).[427] Proposed Item 10 would also extend the current Rule disclosure by requiring franchisors to disclose any interest on the financing in terms of an annual percentage rate, consistent with other consumer credit transactions. It would also require 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.[428]

2. The record and recommendations

Two commenters voiced concerns about Item 10, as proposed in the NPR. First, H&H suggested that leases referred to in Item 10 should be called "'finance leases,' a well-established term in commercial law." H&H, Comment 9, at 18. Second, David Gurnick suggested that the Rule permit negotiation of financial terms: "The franchisor should be expressly permitted to disclose a range within each of the categories in the Item 10 table. The Commission may wish to provide that if a franchisor negotiates financing terms, the franchisor must disclose that there are other sources of financing, such as banks, which the franchisee should consider." Gurnick, Comment 21, at 6-7.

The staff recommends that the Commission adopt proposed Item 10, as set forth in the NPR.[429] While "finance leases" may be a term of art used in commercial law, we do not believe that the UFOC Guidelines, upon which proposed Item 10 is based, are ambiguous or otherwise unclear. Accordingly, we believe deviating from the UFOC Guidelines on this point is unwarranted. Mr. Gurnick's concern about negotiating franchise terms, however, has substantial

---

franchise relationship. Accordingly, it concluded that it is both unfair and deceptive for a franchisor to fail to disclose or misrepresent financing terms and conditions, and to fail to disclose rebates received in connection with franchise financing. 43 Fed. Reg. at 59,659-60. Indeed, the Commission has long recognized that financing arrangements have the potential to injure unsuspecting consumers and are therefore material. *See* Preservation of Consumers' Claims and Defenses, 16 C.F.R. Part 433 (protecting consumer's claims and defenses); Credit Practices Rule, 16 C.F.R. Part 444 (restricting use of waivers, security interests, co-signers, late charges). *Cf.* Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq.*

[426] 12 C.F.R. Part 213.

[427] 12 C.F.R. Part 226.

[428] The introduction to UFOC Item 10 makes clear that franchisors may provide this information in summary table format, and Appendix A to the proposed Rule offers a sample table.

[429] We note, however, that the NPR included a footnote stating that franchisors need not disclose in Item 10 payments due within 90 days on open account financing. 64 Fed. Reg. at 57,337 n.8. We recommend that this explanation be placed in the Compliance Guides.

merit. We, therefore, recommend that the Commission explain in the Compliance Guides that nothing in proposed Item 10 restricts the parties' ability to negotiate over financing terms.

Finally, we also find merit in Mr. Gurnick's suggestion that a franchisor who negotiates financing terms should disclose that other sources of financing are available. However, we are reluctant to expand the Rule to compel franchisors to dispense general advice, absent compelling circumstances. Rather, we believe suggestions such as this one are best handled in Commission consumer education materials.

M. Proposed Section 436.5(k) Item 11: Franchisor's Assistance, Advertising, Computer Systems, and Training

1. Background

The Franchise Rule currently requires franchisors to disclose their obligations to franchisees with respect to pre-opening assistance (e.g., site selection), as well as ongoing assistance (e.g., training, and advertising).[430] More comprehensive disclosures are found in Item 11 of the UFOC Guidelines.

During the ANPR proceeding, two commenters raised concerns about UFOC Item 11, upon which proposed Item 11 is based. UFOC Item 11 enables franchisors to describe their pre-opening contractual obligations in tabular form, with cross references to the corresponding provisions of the contract. In that regard, it parallels proposed Item 9 (franchisee's obligations), described above. Harold Brown, a franchisee advocate, contended that short-hand references to the 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." Brown, ANPR 4, at 5. Mr. Brown urged the Commission to require a franchisor to provide prospective franchisees with a more in-depth analysis of each of the franchisor's obligations. *Id.*[431]

In addition, Harold Kestenbaum, a franchisor representative, raised a concern about the disclosures for computer systems. UFOC Item 11 requires franchisors to disclose information about the nature of their computer systems and any assistance available to franchisees concerning

---

[430] *See* 16 C.F.R. §§ 436.1(a)(17) and (18). The offer of business assistance is one of the hallmarks of a franchise system. In the SBP, the Commission stated that promises of assistance made to induce prospective franchisees to purchase a franchise are material, especially to those prospects with "little or no experience at running a business." 43 Fed. Reg. at 59,676-77.

[431] We believe that the purpose of Item 11 is not to explain the contract, but to give prospective franchisees information with which to conduct a due diligence investigation of the franchise offering. If for any reason a prospective franchisee finds the franchise agreement unclear, or otherwise unfavorable, he or she need not sign it.

such systems. Mr. Kestenbaum did not disagree with the need for the disclosure, but noted 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." Kestenbaum, ANPR 40, at 2.

In the NPR, the Commission proposed expanding the current Rule provisions in several respects, consistent with the UFOC Guidelines.[432] First, proposed Item 11 would alert prospective franchisees that the franchisor is not obligated to provide any assistance except as specified in the disclosure document. This alert is necessary to counter any oral misrepresentations to the contrary and to correct any misconception on the prospective franchisee's part that some degree of assistance is inherent in each franchise offer.[433]

Second, the NPR would require a franchisor to explain in greater detail the franchisor's site selection criteria, as well as the nature of the franchisor's training program. It would also require additional disclosures concerning the extent of advertising assistance and the operation of local, regional, and national advertising co-ops. These disclosures address a common franchisee complaint, namely, that franchisees do not get the quality or quantity of advertising they pay for.[434]

---

[432] 64 Fed. Reg. at 57,306.

[433] Our law enforcement experience demonstrates that misrepresentations about the level of support and assistance is one of the most common problems in franchise cases. *See* Staff Program Review at 24-26 (next to earnings claims, support problems are the second most frequent issue raised by franchisee complainants). *E.g., FTC v. Car Wash Guys Int'l, Inc.,* No. 00-8197 (C.D. Cal. 2000); *FTC v. Indep. Travel Agencies of Am. Assoc., Inc.,* No. 95-6137-CIV Gonzalez (S.D. Fla. 1995); *FTC v. Sage Seminars, Inc.,* No. C95-2854-SBA (N.D. Cal. 1995); *FTC v. Skaife*, Bus. Franchise Guide (CCH) ¶ 9555 (C.D. Cal. 1990).

Indeed, misrepresentations about support and assistance continue to be a source of numerous franchisee complaints. For example, Marge Lundquist told us that her outlet failed, in part, because the franchisor did not adhere to its own criteria in selecting a store. Based upon her experience, she asserted that it is very important to have full disclosure on site selection criteria. Lundquist, ANPR, 22Aug97 Tr, at 45. *See also* Dady & Garner, ANPR 127, at 4; Mousey, ANPR, 29July97 Tr, at 4-7.

[434] *See, e.g., Car Checkers of Am.,* Bus. Franchise Guide (CCH) ¶ 10,163 (misrepresenting that advertising expenses would be minimal or low); *U.S. v. Fed. Energy Sys., Inc.,* Bus. Franchise Guide (CCH) ¶ 8,180 (C.D. Cal. 1984) (misrepresenting extent of company advertising assistance); *U.S. v. Ferrara Foods, Inc.*, Bus. Franchise Guide (CCH) ¶ 7,926 (W.D. Mo. 1983) (misrepresenting availability of national media advertising). The issue of advertising funds continues to generate concerns on the part of franchisees and their advocates. *E.g.,* Brown, ANPR 4, at 3 (favoring restrictions on franchisor's unreasonable use of advertising funds); Manuszak, ANPR 13 (franchisor refuses to account for use of franchisees' advertising funds);

Third, proposed Item 11 would address major technological changes in franchising since the Rule was promulgated in the late 1970s. Specifically, it would entail greater disclosure about the required use of computers and electronic cash registers.[435] For example, it would require franchisors to disclose whether they will have independent access to information and data stored on electronic cash register systems or software programs.[436] On the other hand, the Commission expressed concern that the detailed disclosures concerning computer systems may not provide adequate guidance to start-up systems. The Commission solicited additional comment on whether the proposed Item 11 computer disclosures are unduly burdensome, particularly on start-up systems, and it solicited alternative disclosures.[437]

2. The record and recommendations

Proposed Item 11's computer system disclosures generated six comments.[438] Some franchisors asserted that the computer system disclosures are burdensome and not helpful to prospective franchisees.[439] Marriott, for example, explained that its Item 11 computer usage

---

Weaver, ANPR 17 (no discretion of use of advertising funds); Rachide, ANPR 32 (mismanagement of advertising funds); Colenda, ANPR 71 (alleging inappropriate use of advertising payments); Zarco & Pardo, ANPR 134, at 5 ("A franchisor should be required to disclose the extent of its veto power over the allocation of any franchisee-generated funds, such as advertising cooperatives.").

[435] In response to the ANPR, a few commenters voiced concerns about obligations to purchase computers or related equipment. *E.g.,* Fetzer, ANPR, 19Sept97 Tr, at 42 (needed to purchase a computer converter, an additional $7,000 expense); Rafizadeh, ANPR, 7Nov97 Tr, at 292 (GNC unilaterally forcing franchisees to pay a new $80 monthly maintenance fee on computer equipment purchased from GNC). *See also* NCA 7-Eleven Franchisees, ANPR 113, at 2 (noting 7-Eleven's use of "point-of-sale" cash registers, which enable headquarters to monitor sales).

[436] 64 Fed. Reg. at 57,338.

[437] *Id*. at 57,306 and 57,330.

[438] In addition to these comments, the AFA urged the Commission to require a disclosure about the extent to which franchisors can withhold assistance from its franchisees. It suggested the inclusion of the following statement: "Your franchisor, regardless of what it has told you, reserves the right to receive your [number] percentage royalty [gross margin] payment while providing you with absolutely no franchise services." AFA, Comment 14, at 5. While we agree with the AFA that contractual obligations are generally separate and distinct under the common law of contracts, we believe that this is another example of an issue that is best addressed through consumer education.

[439] Baer, Comment 11, at 13; J&G, Comment 32, at 11; Marriott, Comment 35, at 15-16.

disclosure "results in four to five pages of disclosure in each of Marriott's offering circulars yet provides little or no benefit to the franchisee." Marriott, Comment 35, at 15-16. These commenters also maintained that the Item 11 computer disclosures are unnecessary because the costs associated with purchasing computers and related equipment are already disclosed in Items 5, 7, and 8.

This view, however, was not universally shared by all franchisor representatives. According to BI, the disclosures for cash registers and computers are not unduly burdensome for franchisors, including start-up franchisors. "In such instances, [start-up] franchisors simply provide disclosure as to current and possible future requirements." BI, Comment 28, at 11.

Further, one franchisee advocate, Howard Bundy, disputed the view that computer system disclosures are immaterial. According to Mr. Bundy, it is important for a prospective franchisee to know what equipment they will have to purchase, as well as maintenance and upkeep costs. A franchisor could comply with Item 11 by simply stating that it has not yet selected a computer system, but intends to do so in the future. Mr. Bundy asserted that this uncertainty creates an issue the prospective franchisee should consider. He further described how a franchisor could comply with the Rule:

> The franchisor might go on to articulate some guidelines it will follow in selecting a system – for example, franchisee input, non-proprietary operating systems, security concerns, remote access, and similar matters. A franchisor might even place a monetary cap on the cost of the system to the franchisee. Thus, even without knowing what precise hardware and software he or she would be required to invest in, the franchisee learned a lot – most importantly that the franchisor is not yet computerized, in itself placing the franchisee at a disadvantage in many, if not most, industries. With full disclosure, even the absence of information, the franchisee can make an informed decision.

Bundy, Comment 18, at 9.

Further, as an alternative to the current UFOC Guidelines computer systems disclosures, two commenters offered similar proposals. H&H suggested that a franchisor should be required to disclose the specifications of any mandatory computer system to the extent known or available. The firm agreed that start-up franchisors may not have identified software systems before they start franchising. The firm suggested that a franchisor should be permitted to satisfy the Item 11 requirements by disclosing that specifications are not known or available.[440] In a similar vein, John Baer suggested that:

> [i]f the Commission believes this type of detailed information is useful, the proposed Franchise Rule should be revised to provide simply that the franchisor disclose in writing to the prospective franchisee prior to signing the contract the

[440] H&H, Comment 9, at 23.

electronic cash registers, computer equipment and software that will be required to be used in the franchisee's business.

Baer, Comment 11, at 13.

We are persuaded that proposed Item 11's computer systems disclosures serve a useful purpose. There is no question that prospective franchisees should be informed of the costs to purchase or lease computer and related equipment or software, as well as any continuing maintenance or upgrade obligations and their associated costs. We also believe that prospective franchisees should understand before the purchase whether the franchisor will have access to information stored on computers or electronic cash registers. Such access very likely would be a key component of the relationship between the franchisor and franchisee.

Nonetheless, the computer usage disclosures as set forth in the UFOC Guidelines appear to go beyond what is material in most instances and may impose unwarranted compliance burdens. Specifically, we are disinclined to require a franchisor to identify each and every piece of hardware and software by brand, type, and principal function, or to identify compatible equivalents and whether they have been approved by the franchisor. We agree with the commenters who noted that some franchisors (start-up franchisors in particular) may not have decided upon specific systems at the time of sale or, even if they did, that the technology very likely will change over the course of the franchise agreement. Thus, the compliance burden to prepare component-specific disclosures may not be outweighed by any tangible benefits to franchisees. We believe that it should suffice for franchisors to describe generally the computer systems to be used, if any; any required purchase and maintenance costs and obligations; and whether the franchisor will have access to information contained in those systems.[441] This information not only will enable prospects to weigh the costs and benefits of purchasing a specific franchise, but will better enable prospects to learn if they will be at a technological disadvantage compared to other franchise systems in the industry.[442]

---

[441] As suggested above, we also recommend that the Compliance Guides make clear that a start-up franchisor can indicate that computer requirements are yet unknown, or otherwise state its policy concerning computer usage, as is warranted.

[442] In addition to the recommended modification of the Item 11 computer disclosures, we also recommend a minor clarification of the Item 11 disclosures regarding the franchisor's operating manual. Under the UFOC Guidelines, a franchisor must disclose the table of contents of its operating manual unless "the prospective franchisee views the manual before purchase of the franchise." UFOC Guidelines, Item 11, at B. vii. Because a franchisor is not likely to know whether a prospective franchisee has in fact viewed the manual, we can assume that many franchisors will elect to disclose the table of contents in all instances. Rather, to make this option meaningful, we believe the franchisor should be able to opt out of this disclosure if it provides a prospective franchisee with the opportunity to review the operating manual.

N. Proposed Section 436.5(l) Item 12: Territory

1. Background

In the NPR, the Commission proposed retaining the current disclosures concerning exclusive territories and sales restrictions.[443] Consistent with the UFOC Guidelines, however, proposed Item 12 would expand these disclosures in several respects, including requiring a franchisor to disclose: (1) the conditions, if any, under which it will approve the relocation of the franchisee's business and the franchisee's establishment of additional outlets; (2) any restrictions on a franchisee from conducting business outside of his or her territory; and (3) any present plans to operate a competing franchise system offering similar goods or services. In addition, proposed Item 12 would warn prospects about the consequences of purchasing a non-exclusive territory, namely, that the franchisor may establish other franchised or company-owned outlets that may compete with the prospective franchisee's location.[444]

2. The record and recommendations

Throughout the Rule amendment process, the territory disclosures have generated a number of concerns. First, franchisees and their advocates have complained about "encroachment," the practice by which a franchisor essentially competes with its franchisees by establishing franchisor-owned or new franchised-outlets in the same market territory, or by selling the same goods through alternative channels of distribution. In other instances, franchisors may compete with their franchisees by purchasing and operating a competing franchise system. Second, some commenters asserted that the UFOC Item 12 territory disclosures do not go far enough. They would like to see Item 12 require franchisors to disclose more information about their past expansion practices, as well as future expansion plans. Third, some commenters questioned the language used to describe territories, urging the Commission to avoid implying that a protected territory is inherent in the concept of franchising. Finally, several commenters offered different views on the form of the proposed warning. We discuss each of these issues below.

---

[443] 64 Fed. Reg. at 57,339. *See also* 16 C.F.R. §§ 436.1(a)(3) and (a)(13). In the SBP, the Commission recognized that sales restrictions and limited territories impact upon a franchisee's ability to conduct business and are, therefore, material. 43 Fed. Reg. at 59,662. *See, e.g., U.S. v. C.D. Control Tech. Inc.,* Bus. Franchise Guide (CCH), ¶ 9851 (E.D.N.Y. 1985); *U.S. v. Fed. Energy Sys, Inc.,* Bus. Franchise Guide (CCH) [1983-85 Transfer Binder] ¶ 8180 (C.D. Cal. 1984); *FTC v. Nat'l Bus. Consultants, Inc.,* Bus. Franchise Guide (CCH) ¶ 9,365 (E.D. La. 1989). *Cf. FTC v. Vendors Fin. Serv., Inc.,* No. 98-N-1832 (D. Colo. 1998); *Int'l Computer Concepts, Inc.,* Bus. Franchise Guide (CCH) ¶ 10,513; *O'Rourke,* Bus. Franchise Guide (CCH) ¶ 10,243; *FTC v. Am. Safe Mktg., Inc.*, Bus. Franchise Guide (CCH) ¶ 9,350 (N.D. Ga. 1989).

[444] *See* UFOC Item 12, Instructions ix, and Sample Answer 12-1.

a. Encroachment

During the Rule Review and ANPR proceedings, franchisees and their advocates complained about "encroachment."[445] They contended that encroachment may have a devastating effect upon an individual franchisee who does not have a contractually protected exclusive territory.[446] One particular commenter, a Supercuts franchisee, expressed the issue this way:

> Over the past five years, my Franchisor has changed its focus from "Parent of Franchisees" to "operator of company owned stores." The Franchisor is now opening company owned stores to compete with its own Franchisees. In this way, the Franchisor cashes in on the name recognition built by the very Franchisees its predatory practices now harm. This practice is predatory because the primary banner under which the Franchisor solicited our money and legal commitment was the growth and well-being of the Franchisee body. But the opening of company owned stores to the detriment of established, successful Franchisee locations demonstrates that existing Franchisees live in a marketplace where, if they are successful, the Franchisor will invariably find the temptation to enter the market as a competitor to[o] great to resist. At that point, the constructive agreements which described the initial relationship no longer protect the Franchisee from the challenges of the better financed Franchisor with in-house legal staffs.

Packer, ANPR 10. Franchisees and their advocates maintained that encroachment is an abusive and unfair trade practice that should be banned under Section 5 of the FTC Act.

In the NPR, the Commission recognized that proposed Item 12 is one of the most important disclosure items, preventing fraud and misleading statements concerning protected territories and competition.[447] To address "encroachment," the Commission proposed adopting the UFOC Item 12 approach, requiring franchisors to disclosure any rights a franchisee may have to an exclusive territory.[448]

---

[445] *E.g.,* Brown, ANPR 4, at 2; Packer, ANPR 10; Manuszak, ANPR 13; Donafin, ANPR 14; Weaver, ANPR 17; Rachide, ANPR 32, at 3; AFA, ANPR 62, at 1; Orzano, ANPR 73; Buckley, ANPR 97, at 3; Marks, ANPR 107, at 2; Zarco & Pardo, ANPR 134, at 2.

[446] For example, Laurie Gaither, an owner of a GNC franchise, reported that the company opened a franchisor-owned outlet in a mall within two miles from her store. She claimed that this development has reduced her profits by 50%. L. Gaither, ANPR 68.

[447] 64 Fed. Reg. at 57,306-07.

[448] In response to the NPR, no commenter questioned the basic assertion that franchisors should disclose information about protected territories.

We continue to recommend that the Commission address issues involving territories through pre-sale disclosure. Whether or not a franchisee should have a protected territory is fundamentally a contractual matter for the parties to determine for themselves.[449] While the record establishes franchisees' concerns about encroachment, there has been no showing made that either a franchisor's expansion within a franchisee's territory or a franchisor's failure to grant protected territories in their franchise agreements constitutes an "unfair" practice, as "unfairness" is defined in Section 5 of the FTC Act.[450] First, the level of harm to individual franchisees as a result of encroachment is far from clear. The Staff Program Review, for example, found only isolated instances of "encroachment" reported to the Commission during 1993-2000. In analyzing franchise complaints allegations, the staff found only six specific encroachment allegations.[451] In addition, five franchisee complaints alleged "no promised locations," and an additional five alleged "misrepresented exclusive territory."[452] Second, there is no record suggesting that harm to individual franchisees as a result of encroachment outweighs potential benefits (expansion of markets and increased consumer choice) to consumers or to competition. Finally, prospective franchisees can avoid potential harm from encroachment by shopping for a franchise opportunity that offers an exclusive territory. For these reasons, the Commission lacks the statutory authority necessary to deem "encroachment" a *per se* unfair practice in violation of Section 5, or to take the drastic step of intervening in private franchisor-franchisee relationships to dictate specific contractual terms regarding territories.

b. Scope of the disclosure

During the ANPR proceeding, a few commenters suggested that the Commission broaden the scope of proposed Item 12. Specifically, these commenters urged the Commission to require greater disclosures about the franchisor's past and future plans to expand markets. For example, Andrew Selden, a franchisee representative, suggested that "Item 12 should be elaborated to require full disclosure of past practice, current intention or future possibility of

---

[449] Absent an express grant of a protected territory, a franchisor is generally free to establish as many outlets (franchisor-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 Enterprises, Inc.,* 90 F.3d 1472 (9th Cir. 1996).

[450] For a discussion of the statutory "unfairness" criteria, see above at section III.A.

[451] Staff Program Review at 59.

[452] Staff Program Review, Chart E.2, at 25. *See also id.* at 39 (Commission complaints in franchise and business opportunity law enforcement actions during the relevant period contained 10 allegations of exclusive territory misrepresentations).

franchisor-sponsored competitive activities that have the prospect of impacting the franchisee's business." Selden, ANPR 133, Appendix B.[453]

In the NPR, the Commission declined to broaden Item 12 as suggested, but solicited additional comment on whether franchisors should disclose current expansions plans, as well as the costs and benefits of such a disclosure.[454] In response, Howard Bundy urged the Commission to require franchisors to disclosure not only competition by the franchisor, but by affiliates, the franchisor's officers, and franchise sellers. According to Mr. Bundy, it is much more likely that such persons will be involved in competitive activities compared to the franchisor itself.[455]

Without exception, franchisors addressing this issue opposed any disclosure of their current development plans. H&H's comment is typical. Most franchisors consider current development plans to be proprietary information "that would place them at a competitive disadvantage if they were to be made publicly available." H&H, Comment 9, at 23. The firm also stressed that franchisors need flexibility to adapt development plans to market realities. "Disclosure of development plans could lead to possible claims by franchisees who anticipated greater or lesser franchise development in a particular area." *Id.*[456]

We recommend that the Commission reject suggestions to broaden Item 12. Disclosure of past expansion practices, in particular, is unwarranted. Prospective franchisees arguably can discover such information on their own by directly observing the number and location of outlets in their community and by speaking with current and former franchisees. Moreover, past practices are not necessarily a predictor of future intent. We also believe that it is unreasonable to require franchisors to disclose hypothetical possibilities about their future expansion. Indeed, by not granting an exclusive territory, the franchisor has effectively reserved to itself the unrestricted right to expand into new or existing locations or to sell its products or services via alternative channels of distribution.[457]

---

[453] *See also* Dady & Garner, ANPR 127, at 4 ("Explicit statements about the nature and extent of protection against same-brand competition that will or will not be provided is essential to an informed buying decision.").

[454] 64 Fed. Reg. at 57,330.

[455] Bundy, Comment 18, at 9.

[456] *See also* Wendy's, Comment 5, at 2; Baer, Comment 11, at 13 ; Lewis, Comment 15, at 15; BI, Comment 28, at 11; J&G, Comment 32, at 12; GPM Rebuttal, Comment 40, at 6.

[457] We also find no compelling reason to deviate from the UFOC Guidelines to broaden the scope of the Rule to require more expanded disclosures covering competition by officers and franchise sellers, as some would suggest. This is particularly true in the absence of evidence in the record demonstrating that officer and franchise sellers competition is a prevalent problem resulting in demonstrated injury to franchisees.

Whether a franchisor should disclose more information about any current policy to develop a franchisee's market area presents a more difficult issue. With respect to expansion, the UFOC Guidelines require a franchisor to disclose only if the franchisor "may establish" other outlets in the area; it does not require the franchisor to disclose its specific plans for the franchisee's territory. Franchisors need to elaborate on their expansion plans only if they have "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." UFOC Item 12C. (emphasis added).

We recognize that prospective franchisees are very likely interested in the franchisor's expansion plans and the competition such expansion may bring. Indeed, the prospective franchisee's profit levels and ultimately their ability to succeed in business may be tied to competition in their location. While a prospective franchisee may be able to measure existing competition by visiting the intended outlet's location, he or she is unlikely to be able to determine the franchisor's plans to develop the market or otherwise to compete with its franchisees.[458]

We are convinced, however, that a franchisor's development plan is proprietary information that a franchisor should not be required to make public.[459] A requirement to disclose such information in fact might harm the franchise system, including its existing franchisees, by discouraging the very expansion and development contemplated. It could also subject franchisors to future liability for fraud or misrepresentation should the franchisor alter, abandon, or delay its stated expansion plans. Further, requiring a franchisor to disclose plans to develop a territory may be costly and burdensome because the franchisor conceivably would have to prepare multiple Item 12 disclosures to focus on each franchise location. The disclosures already contained in Item 12 are sufficient to warn prospects about likely competition because any prospective franchisee who buys a franchise without any protected territory is essentially taking the risk that the franchisor will further develop the market area.

Nonetheless, the staff recommends that the Commission update the scope of the Rule's territory disclosures to address changes in the marketplace, such as ecommerce and alternative channels of distributing the franchisor's goods. Currently, the Rule focuses on the extent to which a franchisee has exclusive rights to a particular geographic location and competition from

---

[458] For example, Dr. Spencer Vidulich, a Pearle Vision franchisee, told us that many franchisees were not told that Pearle Vision was going to be purchased by a competing optical chain. "Had they known they were going to be in competition with their franchisor, many of them may have thought differently about purchasing stores. At the very least, I think that would have been information that may have figured into their equation of buying stores." Vidulich, ANPR, 22Aug97 Tr, at 17. *See also* Gray, ANPR 22 (franchisor sold to competitor); Doe, ANPR, 7Nov97 Tr, at 268-70 (franchisor sold to larger company that is now competing in the same market).

[459] *E.g.,* Wendy's, Comment 5, at 2.

franchised or company-owned outlets.[460] Proposed Item 12's focus on potential competition from other outlets is, therefore, potentially misleading because it fails to disclose the extent to which a franchisor may compete with a franchisee through alternative means, in particular through the Internet.[461] Accordingly, we recommend that the Commission broaden Item 12 of the NPR for the limited purpose of providing prospective franchisees with material information about competition not only through outlets within the prospective franchisee's intended location, but through alternative channels of distribution, such as the Internet, catalog sales, telemarketing, and other direct marketing.

To that end, we recommend that the Commission revise Item 12 to require franchisors to disclose, among other things, the franchisor's right to conduct business within the franchisee's territory, including through traditional and alternative methods of distribution, such as though the Internet, catalog sales, telemarketing, or other direct marketing sales. Similarly, the franchisor would disclose any restrictions on the franchisee from conducting business outside of his or her territory through traditional sales and alternative channels of distribution. We believe the amended proposal strikes the correct balance between the franchisor's right to maintain proprietary information and the prospective franchisee's right to know the limitations of the franchise they may purchase.

c. Market area

In the NPR, the Commission proposed that franchisors disclose information "concerning the franchisee's market area with or without an exclusive territory." It also referred to the franchisee's "defined area." 64 Fed. Reg. at 57,339. Several commenters raised concerns about the use of these terms.

First, BI opposed the use of the term "exclusive territory," urging the Commission to use the term "protected territory" instead. "We believe 'protected territory' is simply more descriptive of a franchisee's typical contractual rights regarding its territory, if any. . . . [E]xclusive . . . is ambiguous and often misleading." BI, Comment 28, at 6. Similarly, the firm opposed the use of the term franchisee's "market area." It maintained that the term "market area" is undefined and imprecise. *Id.* at 6-7. BI would prefer the word "location."

The NFC agreed, asserting that the term "market area" is a "charged word." NFC, Comment 12, at 29. According to the NFC, under franchisee agreements, franchisees have, at most, a right only to a specified location or narrowly defined geographic area. Use of "market area" may advance the false notion that the grant of a franchise inherently "confers upon a franchisee exclusive rights within the franchisee's economic 'market area,' despite the terms of

---

[460] 16 C.F.R. § 436.1(a)(13).

[461] *E.g.,* PRM&W, Comment 4, at 11.

the subject franchise agreement." *Id.*[462] Similarly, the NFC opposed the use of the term "defined area." In its view, the appropriate term should be "limited protected territory," noting that an area is almost never granted unconditionally by a franchisor. The NFC advised us that by using the phrase "limited protected territory" in lieu of "defined area," the Commission could "actually reduce the misconception which otherwise may be engendered in the minds of prospective franchisees over what territorial protections, in any, they can expect to receive." *Id.* at 30.[463]

The staff agrees that the language of proposed Item 12 could be clearer. The term "market area" could inaccurately imply an inherent right to a territory, where, in fact, the right to a territory, protected or otherwise, is purely a matter of contract. We also recognize that some commenters opposed the use of the term "exclusive territory." However, that is the term used in the UFOC Guidelines,[464] and we see no compelling reasons to deviate from its use in the revised Rule. In conclusion, we recommend that in the final revised Rule the Commission substitute the words "location" or "exclusive territory" for "market area," "area," and "defined" area, as appropriate.

d. Warning

In the NPR, the Commission supported the inclusion of the following warning in the Item 12 disclosure where franchisors do not offer protected territories: "You will not receive an exclusive territory. [Franchisor] may establish other franchised or franchisor-owned outlets that may compete with your location." 64 Fed. Reg. at 57,339. At the same time, the Commission inquired into the adequacy of the proposed warning and solicited alternatives.[465]

Comments on the NPR's proposed warning were mixed. John Baer, for example, opined that the proposed warning is adequate to alert prospects about potential competition from within the system.[466] Others, however, advised that the warning, as drafted, has the potential for misleading prospects because it narrowly focuses on competition within the franchisee's location, but ignores potentially more significant competition from other sources, such as the Internet, direct mail, and mail order:

---

[462] *See also* J&G, Comment 32, at 12.

[463] *See also id.*

[464] *See, e.g.,* UFOC Item 12 ("Describe any exclusive territory granted the franchisee. Concerning the franchisee's location (with or without exclusive territory, disclose . . ."). *See also* NASAA Comparison at Item 12.

[465] 64 Fed. Reg. at 57,330.

[466] Baer, Comment 11, at 13. *See also* NFC, Comment 12, at 30.

> [W]hat about competition from alternative channels of distribution, such as mail order or Internet sales, or competition from an affiliated company using a different brand name for a similar or competitive concept? Do these alternative forms of competition render a territory something less than "exclusive"? Such competition may actually have more impact than the development of a new same-brand outlet near the franchisee's outlet.

PMR&W, Comment 4, at 11.[467] PMR&W offered the following alternative warning: "You will not receive an exclusive territory. You may face competition from other franchisees or franchisor-owned outlets or from other channels of distribution or competitive brands that we control." *Id.*

Given the potential financial risks associated with a non-protected territory, the staff believes that franchisors who offer no exclusive territory should warn prospective franchisees about the consequences.[468] While we generally disfavor the use of warnings that merely repeat what is already expressly stated in the franchise agreement, we believe that a specific warning regarding exclusive territories is warranted in light of franchisee complaints regarding territory issues. Moreover, this approach is entirely consistent with the UFOC Guidelines.[469] Nonetheless, we agree that the warning should be broad enough not only to cover competition directly in the territory, but from other sources. Accordingly, we recommend that the Commission adopt the language offered by PMR&W, as noted above.

---

[467] *See, e.g.,* J&G, Comment 32, at 12. *See also* IL AG Rebuttal, Comment 38, at 3.

[468] Indeed, several franchisee advocates urged the Commission to strengthen the existing UFOC Guidelines' encroachment risk factor. For example, Robert Zarco suggested that franchisors 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.

Zarco & Pardo, ANPR 134, at 2. *See also* Dady & Garner, ANPR 127, at 3 (suggesting: "You have no protected area. Your franchisor, without any compensation to you, may place another store in a location that may completely erode your profitability.").

[469] *See* UFOC Item 12, Sample Answer 12-1.

O. Proposed Section 436.5(m) Item 13: Trademarks

1. Background

In the NPR, the Commission proposed expanding the disclosure of trademark information.[470] Under the current Rule, a franchisor need only note its trademark.[471] Consistent with the UFOC Guidelines, proposed Item 13 would extend the current Rule by requiring franchisors to disclose whether the trademark is registered with the U.S. Patent & Trademark Office;[472] the existence of any pending litigation, settlements, agreements, or superior rights that may limit the franchisee's use of the trademark; and any contractual obligations to protect the franchisee's right to use the mark against claims of infringement or unfair competition.

2. The record and recommendations

Only one commenter voiced any concern about proposed Item 13, as proposed in the NPR. Howard Bundy suggested that franchisors should disclose not only pending trademark litigation, but all such litigation in the last 10 years. "Lets close the loop and require disclosure of any material adverse trademark litigation outcomes, including settlements and arbitration awards." Bundy, Comment 18, at 9.

Based upon the record, the staff recommends that the Commission adopt proposed Item 13, as set forth in the NPR, with two minor corrections consistent with the UFOC Guidelines. As a preliminary matter, we believe the NPR's proposed expansion of the trademark disclosures is consistent with the Commission's long-standing policy of requiring franchisors to disclose the material costs and benefits of the franchise sale. One of the principal reasons that a consumer may wish to purchase a franchise – as opposed to starting their own business – is the right to use the franchisor's mark, which presumably creates an instant market for the franchisee's goods or

---

[470] 64 Fed. Reg. at 57,307.

[471] 16 C.F.R. § 436.1(a)(1)(iii).

[472] UFOC Guidelines Item 13 provides that if the mark is not registered, the franchisor must include 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." UFOC Item 13A, Instructions, iii. We doubt many prospective franchisees will understand this provision, in particular the phrase "presumptive legal rights." Accordingly, we propose substituting the following simpler warning: "Our trademark is unregistered. Therefore, our right to use the trademark may be challenged. If so, franchisees may have to change to an alternative trademark, which may increase your operating costs."

services.[473] For that reason, trademark usage is one of three definitional elements of the term franchise. Any pending litigation, settlement restrictions, or other potential limitations on the use of the trademark are material because they will necessarily affect the value of the trademark to a prospective franchisee and ultimately may impact upon the franchisee's ability to continue operating the business.[474]

Nonetheless, we would modify proposed Item 13 in two respects. First, the NPR proposed that franchisors disclose how any infringement, opposition, or cancellation proceeding "affects the franchised business." 64 Fed. Reg. at 57,339. This is unnecessarily inconsistent with the wording of the UFOC Guidelines, which state "affects the ownership, use, or licensing" of the trademark.[475] Second, the NPR included a footnote addressing the use of summary opinions of counsel: "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." 64 Fed. Reg. at 57,339. The footnote, however, did not address the discretionary use of a full opinion letter, nor the need to attach the full opinion letter if a summary is used. On this point, the UFOC Guidelines state:

> The franchisor may include an attorney's opinion relative to the merits of litigation or of an action if the attorney issuing the opinion consents to its use. The text of the disclosure may include a summary of the opinion if the full opinion is attached and the attorney issuing the opinion consents to the use of the summary.

UFOC Guidelines, Item 13B Instructions, v.[476] We recommend that the Commission adopt the UFOC Guidelines' language in both instances.

We reject, however, the assertion made by Mr. Bundy that prior trademark litigation is necessarily material to prospective franchisees. What influences an investment decision is whether there are any current restrictions or disputes over the trademark license. Obviously, any existing trademark restrictions or challenges not only may decrease the value of the mark and the goodwill associated with it, but may increase franchisees costs if they must switch to a different mark. The fact that the franchisor may have been involved in trademark litigation in the past is

---

[473] In the SBP, for example, the Commission noted that a key feature of franchising is the right to use the franchisor's trademark. 43 Fed. Reg. at 59,623.

[474] The proposed Item 3 litigation disclosure provision ordinarily does not address trademark litigation. Similarly, the proposed Item 9 and 11 disclosures concerning franchisor obligations do not address the franchisor's obligation to defend the trademark.

[475] *See* NASAA Comparison, at 17.

[476] *See also id.*

not inherently material.[477] Accordingly, we believe that there is no compelling reason to deviate from the UFOC Item 13 model in this instance.

P. Proposed Section 436.5(n)
Item 14: Patents, Copyrights, and Proprietary Information

1. Background

In the NPR, the Commission proposed adopting UFOC Item 14, ensuring that franchisors disclose information about their intellectual property.[478] Specifically, proposed Item 14 would require franchisors to describe in general terms the types of intellectual property involved in the franchise and any legal proceedings, settlements, and restrictions that may impact the franchisee's ability to use such intellectual property. There is no comparable disclosure provision in the current Rule.[479]

2. The record and recommendations

In response to the NPR, no commenters raised any concerns about proposed Item 14. Accordingly, the staff recommends that the Commission adopt proposed Item 14, as drafted in the NPR, with one minor charge. Specifically, we recommend that the Commission revise the provision concerning the use of a counsel's opinion. Proposed NPR Item 14 referred only to a summary opinion. Consistent with the UFOC Guidelines and proposed Item 13 above, the Rule should state: "If counsel consents, the franchisor may include a counsel's opinion or a summary of the opinion if the full opinion is attached."[480]

---

[477] On this issue, the UFOC Guidelines specifically note that a franchisor need not disclose historical challenges to registrations of trademarks that were resolved in the franchisor's favor. UFOC Guidelines, Item 13B Instructions, iv.

[478] 64 Fed. Reg. at 57,307-08.

[479] Restrictions on the use of the franchisor's intellectual property are material because they not only may seriously diminish the value of the franchise, but could undermine the franchisee's ability to operate the business. Proposed Item 14 also may improve the relationship between franchisors and franchisees by preventing any misunderstanding about the value or use of the franchisors' intellectual property.

[480] *See* NASAA Comparison, at 20.

Q. Proposed Section 436.5(o)
Item 15: Obligation to Participate in the Actual Operation of the Franchise Business

1. Background

As proposed in the NPR, Item 15 would require franchisors to disclose whether franchisees are required to participate personally in the direct operation of the franchise.[481] Consistent with UFOC Item 15, proposed Item 15 would expand the current Rule disclosures by requiring franchisors to disclose: (1) participation obligations arising not only from the parties' franchise agreement, but from other agreements or as a matter of practice; (2) whether direct participation is recommended; and (3) any limitations on whom the franchisee can hire as a supervisor and any restrictions that the franchisee must place on his or her manager. If the franchisee operates as a business entity, the franchisor must also disclose the amount of equity interest, if any, that the supervisor must have in the franchise.

2. The record and recommendations

Proposed Item 15 generated one comment. NASAA urged the Commission to consider expanding Item 15 to "include operating hours and the method used by franchisors to notify franchisees of changes in required operating hours." NASAA, Comment 17, at 4. While we believe NASAA's suggestion has merit, we are reluctant to recommend that the Commission adopt it. While information about operating hours may be useful information for prospective franchisees, we do not believe that the need for a new disclosure is so compelling as to justify an inconsistency between the Rule and UFOC Guidelines on this issue. We conclude, therefore, that the Commission should retain Item 15, as proposed in the NPR.

R. Proposed Section 436.5(p)
Item 16: Sales Restrictions

1. Background

Proposed Item 16 would retain the current Rule's disclosures on sales restrictions. Like other Rule provisions addressing how a franchisee may conduct business, it requires franchisors to disclose any restrictions limiting the goods or services that the franchisee may offer for sale or

---

[481] 64 Fed. Reg. at 57,308. *See* 16 C.F.R. § 436.1(a)(14). In the SBP, the Commission noted that the degree of personal participation required of a franchisee is a material fact in the franchise relationship. Accordingly, the omission of such information is an unfair or deceptive practice in violation of Section 5. 43 Fed. Reg. at 59,663.

the customers to whom a franchisee may sell.[482] Consistent with UFOC Item 16, proposed Item 16 would also extend the current Rule disclosures by requiring a franchisor to disclose whether the franchisor has the right to change the types of goods and services authorized for sale, as well as any limits on the franchisor's right to make such changes. These disclosures better enable a prospective franchisee to understand the extent to which the franchisor has the contractual right to control sales, which may directly affect the prospect's ability to conduct business, its independence from the franchisor, and ultimately, its profitability.

2. The record and recommendations

In response to the NPR, no commenters raised any concerns about proposed Item 16. The staff, therefore, recommends that the Commission adopt proposed Item 16, as set forth in the NPR.

S. Proposed Section 436.5(q) Item 17: Renewal, Termination, Transfer, and Dispute Resolution

1. Background

In the NPR, the Commission proposed adopting UFOC Item 17, which 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 expiration of the franchise agreement, post-term covenants not to compete, and assignment and transfer rights.[483] For each category, the franchisor must reference the applicable franchise agreement provisions and briefly summarize the governing terms.[484] This approach would

---

[482] 64 Fed. Reg. at 57,308. *See also* 16 C.F.R. § 436.1(a)(13). In the SBP, the Commission recognized that sales restrictions are material because they can limit the scope of the franchisee's market and ultimately the franchisee's profitability. 43 Fed. Reg. at 59,661. The proposed sales restriction disclosures are comparable to other Commission trade regulation disclosures concerning restrictions on the use of goods and services. *E.g.,* Telemarketing Sales Rule, 16 C.F.R. § 310.3(a)(1) (requiring disclosure of all material restrictions, limitations, or conditions to purchase, receive, or use the goods or services); Negative Option Rule, 16 C.F.R. § 425.1(a)(1)(ii) (requiring disclosure of post-sale minimum purchase requirements); Disclosure of Warranty Terms and Conditions, 16 C.F.R. § 701.3(a)(8) (requiring material disclosures of limitations and exclusions on warranty coverage).

[483] 64 Fed. Reg. at 57,308.

[484] In the SBP, the Commission stated that the terms and conditions of the franchise relationship – such as those governing transfers, renewals, and terminations – are material because they "may limit what the franchisee may do with his or her capital asset." 43 Fed. Reg. at 59,664. Given the length and complexity of the typical franchise agreement, prospective

greatly streamline the Rule, which currently requires franchisors to detail the rights and obligations already spelled out in the franchise agreement.[485] It should also reduce compliance burdens, while providing prospective franchisees with a detailed road map to the contract, where they can read the various provisions in greater detail. At the same time, proposed Item 17 would extend the current Rule by requiring dispute resolution disclosures, including any arbitration or mediation requirements, as well as forum-selection and choice of law provision disclosures.

2. The record and recommendations

Most of the comments submitted on proposed Item 17 concerned the use of the term "renewal." Franchisee advocates asserted that the term "renewal" is misleading. In their view, the term implies that a franchisee, upon expiration of the franchise term, can continue operating the franchise under substantially similar terms and conditions. They observed, however, that franchisees who wish to continue operating their franchises at the end of the franchise term must often sign new contracts that impose substantially different terms and conditions, such as higher royalty payments or the elimination of an exclusive territory. They asserted that franchisees, in many instances, have no choice but to sign even the most abusive, one-sided renewal contracts because they have a substantial economic investment in their franchises and simply cannot walk away without incurring significant economic loss.[486] Worse, when a franchisee does walk away, he or she is often bound by a covenant not to compete, which restricts his or her ability to operate a similar business for a number of years. For example, the AFA stated:

> "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

---

franchisees may overlook, or do not fully appreciate, such terms and conditions. *Id.* Indeed, as noted above at section III, the overwhelming number of ANPR comments were submitted by franchisees voicing various franchise relationship concerns. These relationship concerns support the continuing need for complete and clear disclosure about the basic franchise relationship terms and conditions.

[485] *See* 16 C.F.R. § 436.1(a)(15) (requiring franchisors to describe 14 categories of terms and conditions).

[486] *E.g.,* AFA, Comment 14, at 5; Bundy, Comment 18, at 4; Karp, Comment 24, at 20-21; Morrell, Comment 31, at 2; Bores, ANPR 9, at 1; Rachide, ANPR 32; Chabot, ANPR 37; Rich, ANPR 65; Orzano, ANPR 73; Geiderman, ANPR 131; Karp, ANPR, 19Sept97 Tr, at 83; Chiodo, ANPR, 21Nov97 Tr, at 303-04.

agreement contains a post-termination covenant not to compete. This is truly "holding a gun to the head" of the "renewing" franchisee.

AFA, ANPR 62, at 2.[487]

The view that the term "renewal" may be inappropriate was supported by some franchisor representatives. The NFC, for example, told us that the term "renewal" is somewhat ambiguous: it could mean either "a simple extension of the existing agreement under the same terms or – as is far more common – the grant of a 'successor franchisor' under the terms being offered at the time that the existing agreement expires." NFC, Comment 12, at 30.[488] However, the NFC did not believe that the term "renewal" is misleading, and it was uncertain whether the ambiguity compels a revision of the Rule. On the other hand, J&G asserted that the term is potentially misleading,[489] and Tricon urged the Commission to avoid its use entirely.[490]

Several commenters, however, maintained that the term "renewal" is clear and requires no modification. For example, John Baer stated that "renewal" is a term of art in franchising and should not be changed. He also observed that the various state relationship laws use that term and "to revise it for disclosure purposes is likely to cause more confusion than clarity." Baer, Comment 11, at 13. Seth Stadfeld, a franchisee advocate, agreed, explaining that the term

---

[487] One franchisee, John Rachide, suggested that during renewal, franchisors should be required to disclose copies of all contracts currently being used. "This would allow prospective and renewing franchisees the opportunity to learn the real world environment of the franchisor's system." Rachide, ANPR 32, at 4. Under the current and proposed Rule, an existing franchisee would receive disclosures only if he or she enters into a new franchise relationship under materially different terms and conditions. *See, e.g.,* Final Interpretive Guides, 44 Fed. Reg. at 49,969. However, a renewing franchisee, like a prospective franchisee, would receive only a copy of the specific contract that would govern his or her relationship with the franchisor. The staff believes that Mr. Rachide's suggested disclosure requirement would be overly burdensome, requiring franchisors to add multiple exhibits to what already can be a lengthy disclosure document. Moreover, franchisees seeking to extend their contracts or enter into a new contract upon expiration can readily speak with other existing franchisees to discover the variations among the franchisor's contracts.

[488] The staff also notes that various franchise contracts examined in the course of franchise investigations routinely state the renewal will be pursuant to the "then current franchise agreement." Use of this or comparable phrases should put prospective franchisees on notice that the terms and conditions under which they will operate their franchise may change if granted a renewal upon expiration of the original agreement.

[489] J&G, Comment 32, at 13.

[490] Tricon, Comment 34, at 6-7.

"renewal" refers to the relationship between the franchisor and franchisee, not to the underlying contract. He also shared Mr. Baer's concern that the term is used in state relationship statues and should not readily be changed.[491]

Several commenters suggested that the Commission adopt various disclosures or warnings for prospective franchisees that would explain the concept of renewal in greater detail. The IL AG, for example, suggested that franchisors make the following statement: "You should learn what changes in your agreement might occur and what rights you have when your contract expires. Renewal may change important contract terms." IL AG, Comment 3, at 7. Similarly, the AFA urged the Commission to include the following warning:

> You do not own your own business. You are leasing the rights to sell our goods/services to the public under our trade name. At the end of your initial [number of years] term, your current contract will expire [terminate]. You will have the choice of signing a new contract written by us at the time of expiration [termination]. The new contract will be written by us with no input from you and will contain materially different financial and operational terms.

AFA, Comment 14, at 5. Howard Bundy suggested that franchisors explain the consequences of a renewal, by including a statement akin to the following:

> [Franchisor] does not agree to continue your franchise agreement on the same terms and conditions after the end of the initial term. As a condition of remaining a franchisee, [franchisor] may require you to agree to a different territory, to a change in mandatory or prohibited goods or services, to change vendors, to pay additional or different fees, to make additional capital investments, and otherwise to agree to disadvantageous contract terms. If you cannot or will not agree to the new terms, you may lose substantially all of your investment. Because there is an agreement to not compete with [the franchisor] you may not be able to continue in the same line of business.

Bundy, Comment 18, at 5.

Based upon the record, the staff recommends only a modest revision of proposed Item 17. We continue to believe that the term "renewal" is a franchising term of art. It generally means that upon the expiration of a contract, the franchisees may have the right to enter into a new contract, where different terms and conditions may apply. Additionally, as several commenters noted, the term "renewal" is used in various state relationship laws, in addition to the UFOC Guidelines. In light of that background, we are reluctant to recommend changing that term, thereby introducing a conflict between federal and state approaches.

---

[491] Stadfeld, Comment 23, at 15-16. *See also* NaturaLawn, Comment 26, at 2.

Regardless, it is clear that many prospective franchisees may not appreciate the legal import of the term "renewal." As Mr. Bundy noted, franchisees often are surprised to discover that "renewal" means the continuation of their franchise relationship under potentially vastly different terms. We are reluctant, however, to substitute another word, such as "re-license." A prospective franchisee may be just as prone to misinterpret the substitute language (e.g., "re-license") as the term "renewal." It short, any term may be misleading if prospective franchisees fail to understand the underlying concept that a franchisor may require a change in contract terms and conditions upon expiration of the original agreement as a condition of renewal.

To address the issue of renewals, we recommend that the Commission revise Item 17 slightly to require franchisors to explain their renewal policy in the summary field for provision (c) (requirements for franchisee to renew or extend). If applicable, the franchisor would also state that "franchisees may be asked to sign a contract with different terms and conditions than their original contract." While we are reluctant to add consumer education notices to the disclosure document, especially where the UFOC Guidelines require no parallel notice, we believe it is warranted in this case given the continued concern raised by franchisee advocates and others. We do not suggest any particular form of explanation because that will depend upon the individual policies of each franchisor. Nonetheless, we propose to offer several examples in the accompanying Compliance Guides.[492]

T. Proposed Section 436.5(r) Item 18: Public Figures

1. Background

Consistent with UFOC Item 18, proposed Item 18 would require franchisors to disclose the involvement of a public figure in the franchise system, including his or her management responsibilities, total investment made in the franchise system, and compensation, if any.[493] This section is substantially similar to the current Rule provision found at 16 C.F.R. § 436.1(a)(19).[494]

---

[492] An example of a renewal explanation may include a statement such as: "If you seek to renew your franchise agreement upon expiration, your contract terms and conditions are likely to change significantly," or "Upon expiration, you will be offered the opportunity to sign a new franchise agreement with the then current terms and conditions. Be aware that these terms and conditions may be different from those in your original agreement."

[493] 64 Fed. Reg. at 57,309.

[494] In the SBP**,** the Commission stated that this information is material because it helps 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. 43 Fed.

2. The record and recommendations

In response to the NPR, two commenters questioned the utility of the proposed disclosure. H&H noted that this Item is seldom, if ever, applicable and urged the Commission to delete it.[495] Howard Bundy agreed, proposing instead that the space be used for more important issues: "It would make more sense to elevate the renewal issue, the gag order issue, and the integration clause issue, and perhaps even the arbitration clause issue to full Item status and move the public figure information elsewhere." Bundy, Comment 18, at 10.

The staff agrees that proposed Item 18 is arguably the least important disclosure item. Since the Rule was promulgated in the late 1970s, the Commission has brought no action under the Rule or Section 5 alleging misrepresentations about a public figure's involvement in a franchise system. Further, the staff rarely, if ever, receives complaints on this issue.[496]

Nonetheless, the disclosure is material in those instances, rare though they may be, when a public figure creates his or her own franchise system or when a franchisor uses a public figure pitchman.[497] Conceivably, a celebrity's involvement in, or endorsement of, a franchise system could create the impression that the franchise is a less risky investment. In that instance, the public figure disclosures are material and their potential benefits to prospective franchisees would outweigh their costs. To that limited degree, these disclosures still serve a useful purpose. On balance, we find no compelling reason to justify deviating from the UFOC Guidelines on this point.

Reg. at 59,677-78.

[495] H&H, Comment 9, at 18.

[496] Of the franchisees who participated in the Rule Review and ANPR proceedings, only one voiced concerns about a public figure. Dianne Mousley purchased a Mike Schmidt's Philadelphia Hoagies franchise, in part based upon the representation that Mike Schmidt, a former baseball player, would be actively involved in the franchise system. However, Ms. Mousley's primary concerns did not involve Mr. Schmidt. Rather, she complained about delays in constructing the store and lack of promised training and support. *See generally,* Mousley, 29July97 Tr, at 1-32.

[497] It is possible that the Rule itself discourages the use of public figure endorsers. Arguably, franchisors would rather avoid the use of public figures than incur the compliance costs and disclosure burdens imposed by the Rule's public figure disclosure provisions.

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

1. Background

Perhaps the most important anti-fraud disclosure, proposed Item 19 of the NPR, addresses the making of financial performance representations.[498] Both the current Rule and UFOC Guidelines permit, but do not require, franchisors to make such representations under limited circumstances. Among other things, the franchisor must have a reasonable basis for the representation[499] and disclose the basis and assumptions that underlie the representation.[500] Franchisors also must include an admonition that a prospective franchisee's actual earnings may differ.[501] Under current Commission law, a financial representation must also be geographically relevant to the market where the offered franchise is to be located,[502] the franchisor must state the number and percentage of those franchisees who have actually earned the claimed amount in the stated time frame,[503] and any historical financial performance claims must be based upon Generally Accepted Accounting Principles ("GAAP").[504]

As proposed in the NPR, Item 19 would harmonize the current Rule approach with the UFOC Guidelines approach in several respects. First, it would eliminate the current Rule's requirement that franchisors provide prospective franchisees with a separate earnings claims document.[505] Rather, any performance claims and their substantiation would appear in the text of the disclosure document. Second, the Commission proposed eliminating the current requirement that all financial performance claims be geographically relevant to the franchise offered for

---

[498] 64 Fed. Reg. at 57,309-10. In the SBP, the Commission found that one of the most frequent abuses occurring in the marketing of franchises is the use of deceptive past and potential franchise sales, income, and profits claims. Indeed, the Commission stated that the "use of deceptive and inaccurate profit and loss statements by franchisors has resulted in a legion of 'horror stories.'" 43 Fed. Reg. at 59,684.

[499] 16 C.F.R. §§ 436.(1)(b)(2); (1)(c)(2); 1(e)(2); UFOC Guidelines, Item 19A.

[500] 16 C.F.R. §§ 436.1(b)(3); 1(c)(3); 1(e)(5)(i); UFOC Guidelines, Item 19B.

[501] 16 C.F.R. §§ 436.1(b)(4); 1(c)(5); 1(e)(5)(iii); UFOC Guidelines, Item 19B Instructions, (c).

[502] 16 C.F.R. §§ 436.1(b)(1); 1(c)(1).

[503] *Id*. at §§ 436.1(b)(5)(i); 436.1(c)(6)(i); 436.1(e)(5)(ii).

[504] *Id.* at §§ 436.1(c)(4); 436.1(e)(2).

[505] 64 Fed. Reg. at 57,310.

sale.[506] Third, proposed Item 19 would permit franchisors, under specific circumstances, to disclose, apart from the disclosure document, the actual operating results of a specific unit being offered for sale.[507] Finally, proposed Item 19 would permit franchisors to furnish supplemental performance information directed at a particular location or circumstance.[508]

At the same time, proposed Item 19 of the NPR would differ from the UFOC Guidelines in three ways. First, it would revise the substantiation required for historical financial performance, permitting greater disclosure of financial information about subsets of franchisor-owned or franchised outlets.[509] Second, proposed Item 19 would retain the current Rule requirement that historical performance claims be prepared according to GAAP.[510] Third, it would require franchisors to include specific preambles in Item 19 that, among other things, would warn prospective franchisees not to rely on unauthorized performance claims.[511]

2. The record and recommendations

a. Voluntary financial performance disclosures

During the Rule Review, the staff raised the issue whether the Commission should mandate the disclosure of financial performance information.[512] After considering the comments, the Commission stated in the subsequent ANPR that it was inclined to leave financial performance disclosures voluntary.[513] While the Commission recognized that financial performance information is material to prospective franchisees, it rejected mandating such

---

[506] *Id.*

[507] UFOC Guidelines, Item 19 Instructions i.

[508] *Id.* at Item 19 Instructions ii.

[509] 64 Fed Reg. at 57,310.

[510] *Id.* at 57,341 n.13.

[511] *Id.* at 57,311

[512] Among other things, staff sought information on: (1) the extent to which franchisors provide financial performance information; (2) the extent to which financial performance information is available to franchisors and whether such information is reliable and accurate; (3) the extent to which current Rule and UFOC Guidelines provisions may inhibit franchisors from disclosing financial performance information; and (4) whether the Commission should consider mandating a uniform, national financial performance disclosure standard. 60 Fed. Reg. at 17,658-59.

[513] 62 Fed. Reg. at 9,118

disclosures in favor of a free market approach. The Commission noted that approximately 20% of franchisors choose to make financial performance disclosures and that prospective franchisees, in theory, can find franchise systems that voluntarily disclose such information. "If prospective franchisees were to seek out such franchise systems, or demand the disclosure of such information from franchisors, ordinary market forces may compel an increasing number of franchisors to disclose earnings information voluntarily, without Federal government intervention." 62 Fed. Reg. at 9,118.

The Commission also observed that prospective franchisees can obtain financial performance 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." *Id.* In addition, prospective franchisees are free to discuss earnings and other financial 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 a financial performance disclosure that would both be useful and not misleading to prospective franchisees. Finally, the Commission noted that mandating financial performance disclosures might impose burdens and costs on existing franchisees without any support in the record showing that such increased burdens and costs are outweighed by benefits to prospective franchisees.[514]

In response to the ANPR, franchisees and their advocates maintained that: (1) performance information is the most material information prospective franchisees need to make an informed investment decision;[515] (2) franchisors already have performance information and it is a deceptive omission for them to fail to disclose this information; (3) franchisors are in the best position to collect and disseminate performance information; (4) a mandated financial performance disclosure will reduce the level of false and unsubstantiated oral and written financial performance claims; and (5) more disclosure regarding performance will benefit the marketplace and competition.[516]

---

[514] *Id.*

[515] Quoting several business texts, Mr. Karp asserted that historical financial performance information is critical to any evaluation of a business. Internal Revenue Service Ruling 59-60, Item D, for example, 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." According to Mr. Karp, the failure of franchisors to disclose historical performance information deprives prospects of material information that is essential in evaluating the franchise offering. Karp, ANPR, 19Sept97 Tr, at 100-03.

[516] *See* ANPR, 62 Fed. Reg. at 9,118. *See also* Brown, ANPR 4, at 4; SBA Advocacy, ANPR 36, at 8; Purvin, ANPR 79; Lagarias, ANPR 125, at 1-2; Dady & Garner, ANPR 127, at 1-2; and Selden, ANPR 133, at 1-2 and Appendix C; Lundquist, ANPR, 22Aug97 Tr, at 46-47.

Franchisors and their advocates, in contrast, uniformly opposed mandatory financial performance disclosures. They contended that: (1) it is impossible for the Commission to create a single performance disclosure format that will be relevant for all industries; (2) not all franchisors have the contractual right to collect extensive financial information with which to prepare a performance disclosure; (3) financial performance data collected from existing franchisees is not necessarily complete and accurate; (4) a mandatory performance disclosure will be misinterpreted as a guarantee of future performance, thus increasing litigation; and (5) mandating financial performance disclosures will have a negative impact upon the franchisor-franchisee relationship.[517]

In addition, a few commenters urged the Commission to coordinate its financial performance disclosure policy with NASAA to promote uniformity. For example, John Tifford stated: "Federal and state regulators must develop a coherent and compatible earnings claim policy in order to ensure that franchisors will not be exposed to risks caused by inconsistent and uncoordinated federal and state policies." Tifford, ANPR 78, at 6.[518] On the other hand, Cendant, representing several major franchise systems, suggested that the FTC prohibit states from mandating financial performance disclosures by preempting the field.[519]

In the NPR, the Commission adopted the same approach as in the ANPR. It reiterated its belief 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." 64 Fed. Reg. at 57,310. In general, no new arguments were raised in response to the NPR either supporting or opposing the mandatory financial performance disclosures.[520]

---

[517] *E.g.,* Duvall, ANPR 19, at 2; Kaufmann, ANPR 33, at 7; Tifford, ANPR 78, at 5; Jeffers, ANPR 116, at 5. *See also* 7-Eleven, Comment 10, at 3 (suggesting that a typical franchisor would be hard-pressed to generate financial performance information without "very extensive and significant effort.").

[518] *See also* AFA, ANPR 62, at 4; IL AG, ANPR 77, at 2; IFA, ANPR 82, at 3.

[519] Cendant, ANPR 140, at 2.

[520] Franchisees continued to argue that performance information is material, that mandating performance disclosures will curb deceptive or false performance claims already being made, and that it is a material omission for franchisors to fail to disclose performance information they possess. *See, e.g.,* AFA, Comment 14, at 2; Bundy, Comment 18, at 1-2; Karp, Comment 24, at 24-25; Morrill, Comment 31, at 1. In their view, prospects also need historical financial performance information in order to conduct a due diligence investigation of the franchise offering. *E.g.,* Karp, Comment 24, at 24. On the other hand, franchisors continued to oppose mandatory financial performance disclosures, maintaining that performance information obtained from franchisees is often unavailable or unreliable, that mandating performance disclosures will

Based upon the record, the staff continues to recommend that financial performance representations remain voluntary. In reaching this conclusion, we recognize that false or misleading financial performance claims represent the most common allegation in Commission franchise law enforcement actions.[521] However, there is no assurance that mandating performance claims will in fact reduce the level of false claims. Indeed, a mandated financial performance requirement might have the unintended effect of forcing honest franchisors to disclose financial information that they believe is unreasonable, incomplete, or inaccurate, while doing little to deter franchisors bent on misrepresenting their performance history. In addition, mandating financial performance disclosures is not cost free. Such a requirement would impose substantial new accounting, data collection, and review costs on all franchise systems, while potentially exposing existing franchisees, upon whose data the franchisor would rely, to more extensive audits. In addition, existing franchisees might be subject to potential liability for indemnification should a franchisor relying on the franchisees' performance data be found to have violated the Rule by failing to furnish accurate financial performance data. No new data, policies, or arguments have been raised in response to the NPR that would lead us to a different conclusion. Accordingly, for the reasons articulated in the ANPR and NPR, we are persuaded that financial performance representations should remain voluntary, consistent with the current Rule and UFOC Guidelines.

b. Geographic relevance and subgroups

In the NPR, the Commission proposed eliminating the current geographic relevance requirement for financial performance representations.[522] This would make the Rule's financial

---

increase litigation, and that prospects can often obtain financial information directly from current and former franchisees. *See, e.g.,* PMR&W, Comment 4, at 2; H&H, Comment 9, at 13; 7-Eleven, Comment 10, at 3; NFC, Comment 12, at 11; IFA, Comment 22, at 10; AFC, Comment 30, at 2; J&G, Comment 32, at 6; Marriott, Comment 35, at 11; GPM, Comment 40, at 6-7.

[521] *See, e.g., FTC v. Minuteman Press, Int'l,* 93-CV-2494 (DRH) (E.D.N.Y.) (1998 Order) (finding that the making of false gross sales and profit representations to prospective franchisees was pervasive in the Minuteman and Speedy Sign-A-Rama franchise systems). *See also, e.g., FTC v. Car Wash Guys, Int'l,* No. 00-8197 (C.D. Cal. 2000); *FTC v. Tower Cleaning Sys,* No. 96 58 44 (E.D. Pa. 1996); *FTC v. Majors Med. Supply,* No. 96-8753-Zloch (S.D. Fla. 1996); *FTC v. Indep. Travel Agencies of Am. Assoc.,* No. 95-6137-CIV-Gonzalez (S.D. Fla. 1995); *FTC v. Mortgage Serv. Assoc.*, No. 395-CV-1362 (AVC) (D. Conn. 1995); *FTC v. Robbins Research Int'l, Inc.,* No. 95-CV-627-H(AJB) (S.D. Cal. *filed* May 16, 1995); *FTC v. Sage Seminars, Inc.,* No. C95-2854-SBA (N.D. Cal. *filed* Aug. 10, 1995). *See generally,* Vidulich, 22Aug97 Tr, at 18-19; Marks, 19Sept97 Tr, at 2-3; Fetzer, 19Sept97 Tr, at 40-41.

[522] 64 Fed. Reg. at 57,310.

performance disclosure requirements consistent with the UFOC Guidelines.[523] At the same time, the Commission proposed revising the current requirement that franchisors disclose the number and percentage of existing outlets known to have attained a represented performance level.[524]

The current number and percentage disclosure may be misleading and may actually discourage franchisors from furnishing financial performance information. Under the Rule and UFOC Guidelines, a franchisor must compare the number of franchisees who have performed at a claimed level against all franchisees in its system, not just against franchisees it has measured or against franchisees in a subgroup:

> 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.

64 Fed. Reg. at 57,311. This approach can mislead a prospective franchisee because it suggests that the franchisor has in fact measured the financial performance of all franchisees, when that may not be true. It also may deflate franchisees' actual performance record. More important, a franchisor may decline to include performance information in its UFOC if, in order to do so, it must first incur the expense of conducting a system-wide franchisee performance analysis.

Instead, the Commission proposed in the NPR that franchisors be permitted to disclose truthful financial performance information about a subgroup of existing franchisees, provided that the information has a reasonable basis and the franchisor discloses: (1) the nature of the universe of outlets measured; (2) the total number of outlets in the universe measured; (3) the number of outlets from the universe that were actually measured; and (4) any characteristics of the measured outlets that may differ materially from the outlet offered to the prospective franchisee (e.g., location, years in operation, franchisor-owned or franchisee-owned, likely competition).[525]

---

[523] The UFOC Guidelines, for example, permit a franchisor selling a franchise in Florida to disclose that franchised outlets in urban areas of Oregon and Washington have averaged a specific profit level. The current Rule, however, does not permit such a performance disclosure because it is not geographically relevant to the prospective franchisee's territory – Florida.

[524] 64 Fed. Reg. at 57,310-11.

[525] *Id.*

The NPR proposal generated several, mostly favorable, comments. For example, according to BI:

> [T]he omission of the geographic relevancy requirement represents the removal of a substantial impediment to franchisors who might wish to provide financial performance data to prospective franchisees, because it will lower the obstacles to, and cost of, compiling the data necessary to produce a meaningful representation. We believe it is unlikely to have any material effect on the quality of such representation, as geographic relevancy is often quite attenuated.

BI, Comment 28, at 11.[526] On the other hand, the IL AG voiced concern that eliminating the geographic relevance requirement would not prevent franchisors from "cherry picking" their best performing franchise locations and then allowing prospects to assume that their performance results will be similar.[527]

Other commenters addressed the proposed substantiation requirements for franchisee subgroups. PMR&W urged the Commission to re-examine the need for the proposed subset disclosures set forth in the NPR. The firm did not necessarily disagree with the requirements in principle, but stated that they may deter the dissemination of financial performance information.[528] This view, however, was not universally held. John Baer, and others, maintained that the proposed disclosures for subgroups "provide franchisors with sufficient guidance about what characteristics of the outlets must be disclosed and how they may differ materially from outlets offered to a prospective franchisee." Baer, Comment 11, at 14.[529] Similarly, Marriott observed that allowing disclosure of subgroup performance is laudable "especially when franchisors are frequently adopting new business strategies which may result in different [financial performance representations], depending upon whether the old or new system format is followed by the franchisees." Marriott, Comment 35, at 11.

---

[526] *See also* Baer, Comment 11, at 13.

[527] IL AG, Comment 3, at 7.

[528] PMR&W, Comment 4, at 12-13.

[529] Mr. Baer, however, questioned the usefulness of a disclosure regarding competition in the market area. *Id.* We note that an existing subgroup of franchisees in a particular location may differ considerably from an offered site in another location in terms of likely competition, making it difficult to compare the two. For example, it could be misleading for a franchisor to use as a test market a rural location with few competitors, if it is selling units in an urban environment. If a franchisor wants to disclose financial data from the rural location, it may do so (assuming it is truthful), but it must also disclose the differences in competition that set the units apart.

Finally, H&H raised a related issue regarding subgroups. Footnote 15 of the NPR states that a historical financial performance representation would have a reasonable basis if it is representative of the usual experience of the system's outlets or a subset of those outlets. The footnote adds that 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 nonrecurring conditions, or if the franchisees used inconsistent systems for reporting financial performance information.[530] Focusing on the last part ("if the franchisees used inconsistent systems"), H&H maintained that this statement is too restrictive, asserting that a franchisor might be able to overcome inconsistent franchisee statements to prepare a reliable financial performance representation. "The burden of the reasonableness of such a representations lies with the franchisor, and the FTC should permit a franchisor to judge what information it is willing to rely on." H&H, Comment 9, and 13-14. H&H urged the Commission to change the language of the footnote to read "may not have a reasonable basis." *Id.*

Based upon the record, we are convinced that the geographic relevance requirement, coupled with the requirement that franchisors disclose number and percentage data based upon all of their outlets, is unnecessarily restrictive, preventing franchisors from sharing material, truthful performance information about subgroups of existing franchisees. Our recommendation to eliminate the geographic relevance requirement and revise the disclosures for subgroups will remove obstacles to making financial performance data available to prospective franchisees, while preventing franchisors from "cherry picking" their best locations. Specifically, the proposal will ensure that franchisors disclose how they derived the performance results of subgroups, so that prospective franchisees can assess for themselves the sample size, the number of franchisees responding, and the weight of the results. In addition, these provisions will better ensure that prospects do not draw unreasonable inferences by requiring franchisors to disclose the material differences between the subgroup-units tested and the units being offered. Finally, we agree with H&H that a franchisor should be permitted to show the reasonableness of financial performance information even if the contributing franchisee data are inconsistent. We recommend modifying the discussion of the reasonableness of historical financial performance representations, as H&H suggested. In an effort to streamline the Rule, however, we would remove the footnote from the Rule and place it in the Compliance Guides, where it can be addressed in greater detail.[531]

---

[530] *See* 64 Fed. Reg. at 57,342 and n.15.

[531] We believe the same would hold true for footnote 16 of the NPR, which addresses franchisors' obligation to make available written substantiation for any financial performance representations.

c. GAAP

In the NPR, the Commission proposed that the Rule retain the current requirement that historical financial performance data be prepared according to GAAP.[532] The Commission adopted the current GAAP requirement to address concerns about the validity of franchisee financial statements used by franchisors to make historical financial performance representations.[533] Not only may some franchisees understate profits, but each could have his or her own accounting system. "Differences between franchisees also occur due to such factors as variations in the drawing accounts of principals, fringe benefits of principals, salaries charged to income, and preparation of statements on a cash rather than an accrual basis." SBP, 43 Fed. Reg. at 59,691. To minimize the potential dangers inherent in using franchisee performance data, the Commission determined that historical performance claims and the data underlying them must have been prepared according to GAAP.

Without exception, the commenters who addressed this issue opposed the GAAP requirement. For example, NASAA advised that GAAP goes beyond what the UFOC Guidelines require and would discourage the making of financial performance representations:

> Based upon the experience of states that register franchise offerings, many franchisors that currently include historical financial performance data in UFOC Item 19 may not prepare them according to GAAP. In some instances, a franchisor's historical financial performance data presented may be accurate and material, yet may not be presented according to GAAP. In many other instances, the franchisor may not be aware whether the data presented is according to GAAP. This requirement would discourage franchisors that have a factual basis for making financial performance disclosures from doing so. In addition, this requirement likely would increase costs to franchisors who do choose to make historical financial performance disclosures by requiring them to obtain an accountant's opinion as to whether their data is presented according to GAAP.

NASAA, Comment 17, at 5.[534]

Based upon the record, we are convinced that the GAAP requirement is unnecessary and may impede franchisors' ability to disclose performance information, to the detriment of both franchisors and prospective franchisees. GAAP is one, but not the exclusive approach, to

---

[532] 64 Fed. Reg. at 57,341 and n. 13. *See also* 16 C.F.R. §§ 436.1(c)(4) and 436.1(e)(2).

[533] *See* SBP, 43 Fed. Reg. at 59,691.

[534] *See also* PMR&W, Comment 4, at 12; H&H, Comment 9, at 13; NFC, Comment 12, at 31; Lewis, Comment 15, at 15; Snap-On, Comment 16, at 3; J&G, Comment 32, at 7; Marriott, Comment 35, at 12; IL AG Rebuttal, Comment 38, at 5.

ensuring the accuracy of historic performance data. Franchisors making historical performance representations should have the flexibility to formulate such representations, provided that such representations are reasonable. Indeed, franchisors always have the burden to establish that any financial performance representations are reasonable. Moreover, it is apparent that some franchisors using the UFOC format have disseminated non-GAAP compliant historical performance representations, without concern on the part of the states. Finally, eliminating the GAAP requirement might reduce compliance burdens, while bringing greater uniformity to federal and state disclosure law.[535]

d. Preambles

In the NPR, the Commission proposed that franchisors include preambles in their Item 19 disclosures providing prospective franchisees with information about the dissemination of financial performance data.[536] This proposal would address two concerns. First, there is evidence in the record that some franchisors falsely state that the Commission or the Franchise Rule prohibits franchisors from making financial information available.[537] Second, our law enforcement experience tells us that prospective franchisee may rely on unsubstantiated financial performance representations.[538]

To address these concerns, the Commission proposed that franchisors include in their Item 19 disclosures a prescribed preamble stating that the Rule permits the making of financial performance representations, but only if set forth in the franchisor's disclosure document.[539]

---

[535] We continue to believe that earnings projections prepared in compliance with American Institute of Certified Public Accountants' standards for financial forecasts are presumed to be reasonable. This policy was set forth in footnote 14 to the NPR. In an effort to streamline the Rule, we propose that this policy be placed in the Compliance Guides.

[536] 64 Fed. Reg. at 57,311.

[537] *E.g.,* CA BLS, ANPR 124, at 1; Lagarias, ANPR 125, at 4. *See also* H&H, ANPR 28, at 8; SBA Advocacy, ANPR 36, at 8; AFA, ANPR 62, at 5; Purlin, ANPR 79, at 2; Jeffers, ANPR 116, at 5.

[538] *E.g., FTC v. Minuteman Press, Int'l,* No. 93-CV-2494 (DRH) (E.D.N.Y.) (1998). *See also* 64 Fed. Reg. at 57,311; ANPR, 62 Fed. Reg. at 9,118.

[539] As proposed in the NPR, the first preamble would read:

> 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: a franchisor

Prospective franchisees could then ask for such information, if they wish, or shop for a system that discloses such information. Further, it would discourage prospects from relying on unauthorized financial performance claims. To drive home these messages, the Commission also proposed that franchisors who do not disclose financial performance information in an Item 19 include a second preamble warning prospective franchisees not to rely on unauthorized performance representations and to report the making of such unauthorized representations to the franchisor, the Commission, and appropriate state agencies.[540]

Several commenters supported the inclusion of preambles in Item 19 in order to clarify the state of the law regarding the making of financial performance representations. In particular, the first preamble would correct the common misstatement that the Rule actually prohibits the making of such representations. According to the AFA, for example, a clarification of the law is crucial: "[T]he great untruth that franchise salespeople have been allowed to perpetrate over the years is the following statement in one form or another – the federal government prohibits us from giving you information regarding the financial performance of [name of our] franchises." AFA, Comment 14, at 3.[541]

> provides the actual records of an existing outlet you are considering buying; or a franchisor provides financial performance information in paragraph (s) of this section and supplements that information by providing, for example, information about possible performance at a particular location.

64 Fed. Reg. at 57,341.

[540] As proposed in the NPR, the second preamble would read:

> 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.

Id.

[541] Several commenters confirmed that such misrepresentations are prevalent and urged the Commission to clarify the Rule to combat such misrepresentations. For example, the California Bar's Business Law Section stated:

> Franchisees have reported to certain members of the California Franchise Legislative Committee that franchisor salespersons informed them during the pre-sale discussions in the offer and sale of a franchise that the FTC Rule prohibited

Other commenters asserted that the preambles, coupled with market forces, will encourage the disclosure of financial data. For example, 7-Eleven stated: "We believe this approach – affirmatively informing would-be investors about the requirements under the Rule and the manner in which such information should be disclosed – when combined with the competitive force of the marketplace, ensures that earnings information can be identified and properly appraised by franchise investors." 7-Eleven, Comment 10, at 3.[542]

A few commenters, however, offered various suggestions for improving the preambles proposed in the NPR. For example, the NFC suggested that the first preamble be revised to read:

> The FTC's Franchise Rule permits a franchisor to include in this disclosure document information about the actual or potential performance of its franchised and/or franchisor-owned outlets . . . or (ii) a franchisor provides financial performance information in this Item 19 and supplements that information by providing, for example, information about possible performance at a particular location or under particular circumstances.

NFC, Comment 12, at 11. The NFC stated that these changes are warranted to ensure that franchisors and franchisees alike do not misconstrue the Rule to mean that franchisors are permitted to provide financial performance information generally, without an Item 19 disclosure.

Howard Bundy advised the Commission to delete the word "possible" in the second section of the first proposed preamble. "There is no reason to open the door to guessing and speculation about how good the location could 'possibly' be or become. Such information is predictably unreliable and subjective." Bundy, Comment 18, at 10.

A few commenters also offered suggested changes to the second preamble, which franchisors would provide in the event they chose not to disclose financial performance data in

---

> them from making earnings claims. Based on these reports, we agree that there is a need to clarify the Rule to make clear that neither the Commission nor the Rule prohibits franchisors from making earnings representations.

CA BLS, ANPR 124 at 1. Peter Lagarias, a franchisee representative, similarly told us: "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, ANPR 125, at 4.

[542] *See also* IFA, Comment 22, at 11; Stadfeld, Comment 23, at 17; H&H, ANPR 28, at 8; Duvall, ANPR 19, at 2; Jeffers, ANPR 116; CA BLS, ANPR 124, at 2; Zarco & Pardo, ANPR 134, at 6. *But see* J&G, Comment 32, at 7 (admonition to prospective franchisees to notify the FTC and an appropriate state agency of an unauthorized earnings claim seems a bit excessive).

an Item 19. For example, the AFA maintained that the preamble should emphasize that the franchisor has chosen not to make financial performance disclosures, suggesting the following language: "Financial performance information is a voluntary disclosure. Our chain, [name of franchise system], has volunteered NOT to disclose that information." AFA, Comment 14, at 3. The NFC offered the following clarification: "We do not make any representations about your franchise's future financial performance or the past financial performance of our company-owned or franchised units." NFC, Comment 12, at 11. Howard Bundy would strengthen the second preamble further to read:

> Financial Performance Information is material to any decision to invest. [Franchisor] does not provide you with Financial Performance Information. The absence of such information makes it very difficult for you to estimate your prospects of success in the business. You should proceed with caution and consult your franchise attorney and other business advisors.

Bundy, Comment 18, at 10.

Finally, some commenters urged the Commission to include a general warning about financial performance information, regardless of whether or not the franchisor voluntarily makes an Item 19 performance disclosure. For example, David Holmes stated that:

> Given the almost universal agreement among franchise practitioners that undocumented earnings claims are generally unreliable and the source of inappropriate expectations by prospective Franchisees, it seems prudent, for the protection of prospective Franchisees, to include express language making it clear what all agree on: unsubstantiated earnings claims are not reliable and should not be relied on.

Holmes, Comment 8, at 7. He suggested that the Commission adopt the following disclaimer: "Any financial performance information (or projections) which is not contained in the disclosure document is unreliable and you shouldn't rely on it. Past results are no guarantees as to future results. While some units have reported the results shown in this disclosure document, there's no guarantee you'll do as well." *Id.*[543]

Based upon the comments, the staff makes the following recommendations. Regarding the first preamble, we agree with the NFC's suggestions that the Commission clarify the preamble to ensure that parties understand that any financial performance claims must be made in an Item 19. We also agree with Howard Bundy that the use of the word "possible" is inappropriate. So revised, the first Item 19 proposed preamble would read:

---

[543] *See also* Baer, Comment 11, at 14; J&G, Comment 32, at 7.

> The FTC's Franchise Rule permits a franchisor to disclose 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 the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about performance at a particular location or under particular circumstances.

With respect to the second preamble, we also agree with the NFC's suggestion that the Commission clarify the meaning of "financial performance" by including the phase "franchise's future financial performance or the past financial performance of company-owned or franchised units." We also believe the second preamble should make clear that franchisors who do not make an Item 19 financial performance claim, nonetheless may provide prospective franchisees with actual records of an existing outlet offered for sale. The revised second preamble, therefore, would read:

> This franchisor does not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name and address], the Federal Trade Commission, and the appropriate state regulatory agencies.

In revising the second preamble, however, we reject the suggestion that the second preamble be turned into a risk factor, as Mr. Bundy and others would suggest. We believe that a broader discussion of financial performance representations is more appropriate in a consumer education context where the issues can be addressed at length. Moreover, we do not share Mr. Bundy's view that the absence of a financial disclosure necessarily signals a riskier investment. It could well be that a company bent on defrauding prospective franchisees manipulates its numbers to create a stronger success image, while a successful system may choose not to disclose numbers because it may not believe that it can make a reasonable disclosure that would be applicable to all potential buyers. In addition, any concern that prospective franchisees need to see actual earnings figures in order to judge success is mitigated by Item 20, which compels the disclosure of franchise failures. Finally, we recommend retaining the admonition requirement in which franchisors making financial performance representations caution that individual performance results may differ. We believe that this admonition, coupled with the second preamble, is sufficient to warn all prospective franchisees about the need to be cautious of unsubstantiated earnings representations. We propose that additional guidance on the subject also be addressed in consumer education materials.

V. Proposed Section 436.5(t)
Item 20: Outlets and Franchisee Information

1. Background

Proposed Item 20 of the NPR would retain the current Rule requirement that franchisors disclose the number of franchised and franchisor-owned outlets, the names and addresses of current franchisees, as well as statistical information on franchise turn-over rates, in particular the number of franchises voluntarily and involuntarily terminated, not renewed, cancelled, and reacquired by the franchisor.[544] Proposed Item 20 would also streamline the current Rule by requiring franchisors to disclose the statistical information in tabular form. It would also extend the current Rule by requiring franchisors to disclose the names, addresses, and telephone numbers of at least 100 current franchisees (as opposed to the current Rule requirement of at least 10 franchisees), as well as the names, addresses, and telephone numbers of those franchisees who have left the system within the last fiscal year.[545]

Although based upon UFOC Guidelines Item 20, proposed NPR Item 20 would differ from the UFOC Guidelines model in several respects. First, proposed Item 20 would correct a double-counting problem brought to the Commission's attention during the Rule Review. In addition, proposed Item 20 would require disclosure about franchisors' use of "confidentiality clauses,"[546] which effectively restrict franchisees from discussing their experiences with

---

[544] 64 Fed. Reg. at 57,311-12. *See also* 16 C.F.R. § 436.1(a)(16). In the SBP, the Commission explained that the required statistical information gives prospective franchisees material information about the size of the franchise system they are contemplating joining and sheds light on the prospect's likelihood of success. "Providing a prospective franchisee with an accurate statement of the number of units operated by his or her franchisor will convey information relating to the financial success of the particular franchise business since the franchisee's ultimate success depends in large measure on public recognition of the franchisor's name." 43 Fed. Reg. at 59,670. More important, the disclosure of current and former franchisees' names and addresses prevents fraud by arming prospects with a valuable, alternative source of information with which to verify franchise sellers' representations. *Id.* at 59,671. For example, current and former franchisees often can verify or discount a seller's representations, in particular financial performance claims. Indeed, one reason the staff rejects mandating financial performance disclosures is that franchisees are the best source of information about their own earnings. *See* ANPR, 62 Fed. Reg. at 9,118.

[545] Current and former franchisees often have widely different experiences. For that reason, in *In Re: Blenheim Expositions, Inc.*, 120 F.T.C. 1078 (1995), the Commission challenged franchisee success claims based upon a Gallup Poll study of current franchisees only.

[546] The NPR used the term "gag clauses." However, for the reasons noted above in the definitions section, we prefer the term "confidentiality clause."

prospective franchisees. Proposed Item 20 would also require the disclosure of trademark-specific franchisee associations.[547] There are no comparable disclosures in either the current Rule or UFOC Guidelines. We address each of these issues below.

2. The record and recommendations

a. Double-counting

As noted above, proposed Item 20 would incorporate the UFOC Guideline's Item 20 disclosure of information about franchisees who have recently left the franchise system, as well as changes in ownership of franchised outlets. During the Rule amendment process, no commenters opposed this disclosure in principle. However, commenters universally voiced concern that UFOC Item 20 is flawed and needs to be fixed.[548] Specifically, UFOC Item 20 results in franchisors "double-counting" changes in franchised outlet ownership, resulting in inflated turnover rates.

In the NPR, the Commission observed that the "double-counting" problem is attributable to at least two factors. First, UFOC Item 20 requires franchisors to report changes in franchised outlets ownership according to five enumerated categories: (1) transfers; (2) canceled or terminated; (3) not renewed; (4) reacquired by the franchisor; or (5) reasonably known to have "ceased to do business." The absence of precise definitions, however, may lead to overlapping reporting categories, resulting in a double-counting of outlet closures.[549] For example, transfers and reacquisitions are often two sides of the same coin. If a franchised outlet goes out of business and the franchisor assumes control, that single event could reasonably be captured either as a transfer by the franchisee, or as a reacquisition by the franchisor.

Second, even if the definitions were clear, UFOC Item 20 can be interpreted to require the disclosure of each of a series of events associated with a single outlet ownership change.[550] For example, after terminating a franchise agreement, the franchisor may reacquire the outlet. The franchisor could then either operate the outlet as a franchisor-owned store, or sell it to a new franchisee. Arguably, under UFOC Item 20, a franchisor would report a termination followed by

---

[547] The proposal would not require franchisors to disclose the existence of broad-based organizations that represent franchisee interests generally, such as the American Franchisee Association, the American Association of Franchisees & Dealers, or the International Franchise Association.

[548] *E.g.,* Kaufmann, RR 33, at 4; AFA, RR 62, at 3; Simon, RR, Sept95 Tr, at 223-24.

[549] UFOC Item 20D. *See* 64 Fed. Reg. at 57,312. *See also* Wieczorek, ANPR, 18Sept97 Tr, at 31.

[550] *See* 64 Fed. Reg. at 57,312.

a reacquisition as two separate events. Similarly, a franchisee may abandon an outlet, and, in response, the franchisor may send the franchisee a formal termination letter, reacquire the outlet, and then transfer it to a new franchisee. Although the outlet has changed hands only once, the franchisor conceivably would report this event four times as a ceased to do business, termination, reacquisition, and transfer.[551]

In the ANPR, the Commission acknowledged the franchise industry's concern about the double-counting problem and solicited comment on how Item 20 could be improved.[552] In response, several commenters confirmed the double-counting problem,[553] but only a few offered concrete solutions, and no consensus emerged on how to correct the problem.

Three commenters suggested that the Commission address double-counting by adding additional categories to the Item 20 disclosure. For example, Robert Zarco recommended that the Commission create multiple 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 franchisees to the franchisor, but ultimately re-franchised; (3) transfers by franchisee directly to new franchisee; and (4) transfers by franchisee directly to new franchisee more than once.[554]

Similarly, the AFA recommended that franchisors create as many categories as needed to capture all combinations of ownership changes that might occur at each outlet during the course of the year. For example, a termination followed by a transfer to a new owner would be reported

---

[551] From these examples, one can readily understand franchisors' concerns that UFOC Item 20 may greatly inflate outlet failure rates. *See* Zarco & Pardo, ANPR 134, at 6 ("If the [Item 20] information becomes too complicated, the potential franchisee will not know how to interpret the data and thus, derive no benefit from the increased efforts at meaningful disclosure."). While the UFOC Item 20 instructions provide that the franchisor can add footnotes to clarify the numbers, this solution may be burdensome. In addition, prospective franchisees may not read or fully appreciate the import of the footnotes.

[552] 62 Fed. Reg. at 9,121.

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

[554] Zarco & Pardo, ANPR 134, at 6-7. *See also* Karp, ANPR 136 (suggesting that the Commission add columns for newly developed outlets and outlets converted from franchisor-owned, as well as distinguish between units not renewed by franchisor and units not renewed by franchisee).

as a "termination and transfer," while a termination followed by a reacquisition to the franchisor and then a transfer to a new franchisee would be reported as a "termination, reacquisition, transfer."[555]

Dennis Wieczorek, a franchisor representative, opined that most double-counting problems are attributable to the inclusion of transfers and reacquisitions in the table summarizing the status of franchised outlets. According to Mr. Wieczorek, transfers and reacquisitions usually follow an initial closing, such as a termination or non-renewal. He suggested that transfers and reacquisitions – which are the consequence of an outlet closure – be offset from the outlet closing statistics. To that end, he proposed that transfers be removed from the main body of the franchisee statistics table and placed in a separate column located on the side of the franchisee statistics table. Further, reacquisitions should be moved to the second Item 20 table concerning franchisor-owned outlets.[556]

Finally, Mr. Wieczorek suggested that double-counting could be reduced by requiring franchisors to report only the change in ownership event that occurs first in time. Thus, for example, a termination followed by a reacquisition would be reported only as a termination.[557] In contrast, a few commenters suggested that the Commission require franchisors to report multiple events according to a predetermined order of priority, rather than by chronological order.[558] For example, the Commission could require franchisors to report multiple ownership changes only once, eliminating "picking and choosing" of categories, by assigning a specific order of priority such as termination, non-renewal, reacquisition, and transfer. Under this approach, a franchisor would report an ownership change as a termination, regardless of what other events may have occurred before (e.g., abandonment of the property) or after (e.g., reacquisition or transfer).

In the NPR, the Commission proposed fixing the double-counting problem as follows:[559] As an initial matter, the Commission proposed a new Item 20 table to capture changes in outlet ownership, containing 10 columns:

---

[555] AFA, ANPR 62, at 3.

[556] Wieczorek, ANPR 122. Mr. Wieczorek has attached sample tables for the Commission's consideration. *Id.* at 3-4.

[557] *Id.* at 2.

[558] Simon, ANPR, 18Sept97 Tr, at 23-24; Tifford, *id.* at 25. *See also* Bundy, ANPR, 6Nov97 Tr, at 230.

[559] 64 Fed. Reg. at 57,312.

Column 1 would disclose the states where the franchisor has outlets;
Column 2 would state the number of outlets opened at the beginning of the year;
Column 3 would state the number of outlets with the same ownership at the end of the year;
Columns 4-6 would state the number of outlets changing hands because of a termination, reacquisition, and transfer, respectively;
Column 7 would state the number of outlets that were not renewed at the end of the franchise term;
Column 8 would state the number of outlets that ceased operation or closed for other reasons;
Column 9 would report the total number of outlets discontinued during the year; and
Column 10 would report the total number of outlets in operation at the end of the year.

In addition, the NPR's proposed Item 20 would address the core source of double-counting – imprecise reporting categories.[560] The Commission proposed defining the three terms "termination," "reacquisition." and "transfer," creating mutually exclusive categories.[561] The Commission also proposed reducing double-counting of turnover information by adopting a "first-in-time" approach:[562] when an ownership change involves two or more events, the franchisor reports only the change that occurs first in time.[563] For example, if a franchisor terminates an outlet and then reacquires it, the "first-in-time" instruction would require the franchisor to report this event as a termination because the franchisor terminated the outlet before reacquiring it or transferring it to a new owner. The Commission believed that this approach, coupled with precise definitions as set out above, would reduce the opportunity that franchisors would pick and choose among reporting categories.[564]

---

[560] For example, several commenters urged the Commission to define the terms "transfers" and "reacquisitions" more precisely. Tifford, ANPR 78, at 4; Wieczorek, ANPR 122, at 1-2.

[561] 64 Fed. Reg. at 57,312.

[562] While the Commission tentatively adopted the proposed "first-in-time" approach, it recognized that the alternative "order of priority" approach might have merit. In order to give this proposal an adequate review, the Commission explored the issue further in the NPR by soliciting specific order of priority proposals. *Id.* at 57,312 and 57,330.

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

[564] To reduce compliance burdens and to foster uniformity with the UFOC Guidelines, the staff has rejected the suggestion that Item 20 be expanded to include additional reporting categories. While the record indicates that Item 20 needs to be fixed to address the double-counting problem, it does not support a *de novo* rewrite of Item 20. Expanded reporting categories arguably would provide prospects with more information; however, the staff is unconvinced that such additional information is necessarily material. *See* Tifford, ANPR, 18Sept97 Tr, at 35-36 (asserting that the Item 20 franchisee table already contains the categories

While the NPR comments continued to support the need to correct the double-counting problem,[565] several commenters believed that the NPR's proposed fix falls short. Some commenters advised that the NPR proposal is too complex and difficult to understand.[566] Eric Karp, for example, stated that the proposed NPR fix "does not fully resolve the double-counting issue and does not go far enough in utilizing important data that prospective franchisees should have at their disposal." Karp, Comment 24, at 11. Others asserted that the NPR proposal overlooks categories,[567] equates categories that should be separate,[568] and, in a few instances, uses inaccurate definitions.[569]

Further, some commenters opposed particular details of the proposal, such as the proposed "first in time" approach. For example, PMR&W suggested that a "last in time" approach for categorizing multiple events would be more accurate:

> A last-in time prioritization is appropriate for at least three reasons: (1) it allows for an easily ascertainable confirmation of the event; (2) it represents a fact, rather than an intention (*e.g.,* a termination notice) or a proposal (*e.g.,* a transfer rather than request); (3) in dispute situations, it labels the event in a manner consistent with the parties settlement of their dispute.

---

needed to capture changes in ownership). Moreover, a prospective franchisee may be less inclined to review Item 20 if he or she must wade through an endless stream of statistics. *See* Simon, ANPR, 18Sept97 Tr, at 23 (asserting that expanded disclosures would be denser and less meaningful); Cantone, *id.*, at 25 ("I think it's critical that the disclosures have got to stay simple to be meaningful.").

[565] *E.g.,* IL AG, Comment 3, at 7; Snap-On, Comment 16, at 4; NASAA, Comment 17, at 5; Karp, Comment 24, at 11.

[566] *E.g.,* IL AG, Comment 3, at 7; PMR&W, Comment 4, at 13; NFC, Comment 12, at 31; Lewis, Comment 15, at 16; NASAA, Comment 17, at 6; Bundy, Comment 18, at 10-11; NaturaLawn, Comment 26, at 1; BI, Comment 28, at 12.

[567] *E.g.,* H&H, Comment 9, at 19 (NPR overlooks number of new outlets opened or acquired by franchisees in the fiscal year); Tricon, Comment 34, at 4-5 (NPR lacks a column to report newly-operated outlets or outlets acquired by a franchisee from a franchisor).

[568] *E.g.,* H&H, Comment 9, at 19 (NPR equates outlet transfer with an outlet closing); NFC, Comment 12, at 32 (NPR confuses changes in ownership with changes involving discontinuance of a location); Frandata, Comment 29, at 10 (NPR confuses changes affecting the franchisee with changes affecting the location).

[569] *E.g.,* PMR&W, Comment 4, at 13 (NPR states that terminations and non-renewals are fully completed upon the sending of an "unconditional notice." "[E]ven if franchisors send such notices, they do not necessarily result in completion of the event described in the notice.").

PMR&W, Comment 4, at 13-14.[570]

Most important, NASAA suggested that UFOC Item 20 needs to be revised in its entirety and submitted for the Commission's consideration an alternative that was produced with the assistance of an Industry Advisory Committee. Several of the commenters have submitted the same proposal or have endorsed the NASAA proposal.[571] Additionally, Eric Karp, a member of the Industry Advisory Committee, has submitted a modification of the NASAA approach for the Commission's consideration.[572]

NASAA's proposed Item 20 would contain five tables.[573] Table No. 1 would indicate the status of a franchisor's system. It would show the number of franchised and company-owned outlets at the beginning and end of each of the last three fiscal years, and the total net change.

Table No. 2 would indicate transfers. NASAA suggested that transfers should be reported separately from terminations and non-renewals. It observed that transfers do not affect the total number of outlets in a franchise system. Further, a transfer by itself tells little about the underlying cause: "While some transfers are problematic for franchisees or prompted from disputes, many other transfers simply reflect a desire on the part of the franchisee to cease operating a franchise or to pursue other opportunities." NASAA, Comment 17, at 8. Nonetheless, the total number of transfers within a system appears to be material. Table No. 2 would indicate the number of franchise transfers in each state over the last three fiscal years.

Table No. 3 would track the franchisor's turnover rate of franchised outlets. It would use a "last in time" approach to resolve double-counting problems, for the reasons cited above. Franchisors would report, for each of the last three fiscal years, the outlets at the start of the year, new outlets opened, terminations, non-renewals, reacquisitions by franchisor, outlets that ceased to do business, and outlets at the end of the year.

---

[570] *See also* IL AG, Comment 3, at 8; NASAA, Comment 17, at 6; Frandata, Comment 29, at 10.

[571] NASAA, Comment 17, at 5-10. *See also, e.g.,* PMR&W, Comment 4, at 14-66 and Exhibit A; NFC, Comment 12, at 31-32; Frandata, Comment 29, at 11.

[572] Karp, Comment 24, at 11-18.

[573] NASAA's comment actually mentioned four tables: it did not discuss the current table for estimated franchise outlet openings. We assume that NASAA favors retaining this table (which would be Table No. 5), but did not mention it because it does not involve the double-counting issue.

Table No. 4 would track the turnover at company-owned stores. Franchisors would disclose, for each of the last three fiscal years, their outlets at the start of the year, new outlets, reacquired outlets, closed outlets, outlets sold to franchisees, and outlets at the end of the year.

Presumably, NASAA would also retain as Table No. 5 the current projected openings table. This table gives prospective franchisees insight into anticipated growth within the system by requiring the disclosure of both projected franchised and company-owned openings in the next fiscal year. It also reveals the number of franchise agreements signed in the previous year where a store has not yet been opened. This information is material because it enables a prospective franchisee to gauge how long it may take before his or her store actually becomes operational.

In a related matter, NASAA urged the Commission to consider requiring franchisors to state the reason why each of the franchisees disclosed on its Item 20 list of former franchisees left the system (e.g., terminated, non-renewed, or otherwise voluntarily or involuntarily ceased to do business): "This information is clearly material. In some cases, prospective franchisees may not be able to contact the franchisees named in this list. In some cases, those franchisees may be unwilling or unable to provide this information to prospective franchisees." NASAA, Comment 17, at 10.[574]

As noted above, Eric Karp submitted a variation of the NASAA proposal for the Commission's consideration. He would greatly expand the NASAA proposal in the following respects. First, Mr. Karp would add more detail to NASAA's proposed transfer table, Table No. 2. Franchisors would disclose not only the number of transfers in each of the last three fiscal years, but also the number of completed transfers, requests for transfer that were denied, and those transfers in progress at the end of the fiscal year.

Second, in Table No. 3, Mr. Karp suggested that new outlets be divided into two categories: new outlets that are newly developed and new outlets that were purchased from a franchisor.[575] NASAA's proposal combines all new outlets in one "new outlet" category.

Third, Mr. Karp urged the Commission to adopt a new table addressing turn-over rates. To that end, Mr. Karp proposed a new table that would calculate a specific turnover rate, expressed as a percentage, by comparing the number of outlets at the beginning of a fiscal year with the number of outlets during the year that were terminated by the franchisor, non-renewed, repurchased by the franchisor, transferred to another franchisee, or ceased operations for other reasons.

Fourth, Mr. Karp proposed revising the new growth projection chart (Table No. 6). Specifically, franchisors would disclose for each of the last three fiscal years: previously

---

574 *See also* Karp, Comment 24, at 19.

575 *Id*. at 14.

projected franchised new outlets, actual number of franchised new outlets; franchise agreements signed but outlet not in operation. and projected franchised new outlets for next fiscal year. According to Mr. Karp, this approach would enable prospective franchisors to assess the accuracy of franchisor's growth projections.[576]

Finally, the IL AG submitted an additional suggestion about turnover rates. It asserted that a number of successive franchises at the same location could indicate "churning," the practice whereby a franchisor turns a blind eye to franchisee failures – or worse, encourages them – in order to sell the same location repeatedly. The IL AG urged the Commission to require franchisors to provide a prospect with a detailed site history when a buyer is being directed to a particular location. "This could be a three year history that would chart prior franchisees, their dates of operation, dates of store management by the franchisor for the site, and the reasons previous franchisees departed from that site." IL AG, Comment 3, at 7.

After careful consideration, the staff recommends that the Commission address the Item 20 double-counting problem by adopting the NASAA proposal.[577] We are persuaded that the NPR's proposed Item 20 double-counting fix is too complex and difficult to understand. In considering an appropriate fix, we give great weight to the fact that several commenters have supported the NASAA alternative proposal. Furthermore, we believe that this proposal will be easily understood by those in the industry, solve the double-counting problem, and provide prospective franchisees with the information they need without imposing undue compliance burdens on franchisors. We do not recommend adopting the expanded disclosures suggested by Mr. Karp. The additional proposed disclosures would greatly increase the size of the Item 20, potentially overwhelming prospective franchisees while increasing franchisor compliance costs.[578]

---

[576] *Id*. at 17.

[577] We also recommend that the Commission revise the scope of terms used in Item 20 to avoid overlapping categories. Specifically, "termination" would mean the franchisor's termination of a franchise agreement prior to the end of its term without paying consideration to the franchisee (whether by payment or forgiveness or assumption of debt. "Non-renewal" would occur when the franchise agreement for a franchised outlet is not renewed at the end of its term. "Reacquisition" would mean the franchisor's acquisition of an outlet prior to the end of its term for consideration (whether by payment or forgiveness or assumption of debt). "Transfer" would mean the acquisition of a controlling interest in a franchised outlet during its term by a person other than the franchisor or an affiliate. *See* Wieczorek, ANPR Comment 122, at 2.

[578] In order to streamline the Rule and reduce inconsistencies with the UFOC Guidelines, we also reject suggestions to add new Item 20 charts that merely restate information that can already be gleaned from the existing charts. For example, if the NASAA proposed Item 20 is adopted, prospective franchisees will be able to calculate turnover rates themselves from the data contained in Tables 1 and 3 by comparing outlets at the beginning of a fiscal year with the

We also agree with the IL AG about the potential problem of "churning." To address this concern, we recommend that the Commission include a new provision in Item 20 that would require a franchisor selling a specific existing unit to provide the prospective franchisee with a history of that unit, including the names, addresses, and telephone numbers of each previous owner and the reasons for the change in ownership.[579] Consistent with the IL AG's proposal, we recommend that this information be disclosed for the last three fiscal years in order to present a more accurate snap-shop of the unit's history. This type of information should be readily available to the franchisor and its disclosure should impose minimal costs. More important, the disclosure of this information is critical if a prospective franchisee interested in buying a specific outlet is to conduct a thorough due diligence investigation. We believe any minimal costs to the franchisor, therefore, are outweighed by the countervailing benefits to prospective franchisees.

b. Confidentiality clauses

In the ANPR, the Commission recognized that confidentiality provisions may harm prospective franchisees by limiting their ability to speak with former and current franchisees during their due diligence investigation of the franchise offering. Accordingly, the Commission solicited comment on the use of confidentiality clauses as follows:

> To what extent do franchisors use "gag orders" to inhibit former or existing franchisees from speaking with prospective franchisees or other parties? Should the Commission modify the Rule to prohibit franchisors from using gag order provisions and, if so, how? What alternatives would ensure that prospective franchisees can freely obtain information from former and existing franchisees about their experience with the franchise system? What would be the costs and benefits of such alternatives?

62 Fed. Reg. at 9,121.[580]

---

number of outlets closed during the year.

[579] This proposal is somewhat analogous to the Item 19 provision that would allow a franchisor to provide supplemental financial performance information about a specific unit being sold. Indeed, we believe that if a franchisor could use the prior performance history of an existing unit to its advantage as a marketing tool, then the prospective franchisee should also be able to obtain comparable turnover rate information in his or her due diligence review of the offer.

[580] The ANPR was not the Commission's first involvement with confidentiality provisions in franchise matters. In 1996, the Commission addressed this issue in *FTC v. Orion Prods.,* 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). While the Commission did not challenge these defendants' use of confidentiality clauses as either a Rule or Section 5 violation in its

The ANPR comments revealed no consensus on the extent to which franchisors use confidentiality clauses. Several franchisee representatives contended that the use of confidentiality clauses is widespread.[581] For example, Susan Kezios of the AFA stated that "the use of gag orders is almost 100 percent in some franchise systems." Kezios, ANPR, 6Nov97 Tr, at 241.[582] This view, however, was not universally shared, even by franchisee advocates. Howard Bundy reported that he does not "see very many of them in practice." Bundy, *Id*., at 236.[583] On the other hand, several franchisor representatives insisted that confidentiality clauses are rare.[584]

This apparent lack of consensus among ANPR commenters was understandable for two reasons. First, these commenters addressed two different confidentiality clause uses: franchisees addressed post-sale confidentiality clauses, while franchisors apparently addressed pre-sale clauses. It is clear from statements in the record that franchisees in many instances sign post-sale confidentiality provisions in settlements[585] and as a condition of termination.[586] On the other

---

complaints, it did obtain fencing-in provisions in settlements that prohibited the defendants from enforcing or entering into confidentiality provisions for a limited time.

[581] Lagarias, ANPR 125, at 3 ("I have found that in most of the actions I have settled, the defendant franchisors and their counsel insist on confidentiality."); Selden, ANPR 133, at Appendix B ("[Confidentiality clauses] are becoming increasingly problematic to franchisees."). *See also* Karp, ANPR, 19Sept97 Tr, at 92-93.

[582] *See also* Karp, ANPR, 19Sept97 Tr, at 93-94.

[583] *See also* Marks, ANPR, 19Sept97 Tr, at 33-34.

[584] *E.g.,* Tifford, ANPR 78, at 3; Duvall, ANPR, 6Nov97 Tr, at 240.

[585] *E.g.,* D'Alessandro, ANPR, 22Aug97 Tr, at 40; Doe, ANPR, 7Nov97 Tr, at 276 Lagarias, ANPR 125, at 3. For example, Caron Slimak, a Jacadi USA franchisee, told us that an agreement she signed upon termination contains 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 parties, 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. Franchisors' forceful defense of confidentiality clauses on the grounds that they promote informal settlement of disputes also tends to support the view that such clauses are common in settlements. *See* Forseth, ANPR, 18Sept97 Tr, at 40. *See also* Marks, ANPR,

hand, it appears that franchisors generally do not include pre-sale confidentiality clauses in their initial franchise agreements.[587] Indeed, no franchisees who commented on this issue stated that they were required to sign a confidentiality provision in their initial franchise agreement.

Second, some confusion about confidentiality clause usage stemmed from how this issue was framed in the ANPR. The ANPR used the term "gag order," which apparently implied that the Commission was limiting its inquiry to confidentiality orders issued by a court in a legal proceeding.[588] In addition, the ANPR may have implied that "gag orders" are imposed by the franchisor. Some franchisors insisted, however, that confidentiality provisions are not imposed, but are mutually agreed upon covenants.[589] Under the circumstances, it is understandable that commenters believed that franchisor-imposed or court-ordered confidentiality provisions are rare. Nonetheless, the record shows that confidentiality clauses – regardless of what they are called and whether they are imposed or mutually agreed upon – are used at least in dispute settlements and when franchisees seek termination.

The ANPR comments also revealed no consensus on whether confidentiality clauses serve a useful purpose. One quarter of the ANPR commenters (42 out of 166 commenters)

19Sept97 Tr, at 8-9.

[586] Several franchisees reported that franchisors routinely require franchisees to sign confidentiality clauses upon termination. *E.g.,* Maloney, ANPR 38, at 2; Doe, ANPR, 7Nov97 Tr, at 276-79; Rafizadeh, *id.* at 299-300; Slimak, ANPR 130; Lundquist, ANPR, 22Aug97 Tr, at 42-43. Others urged the Commission to prohibit the practice. *See* Manuszak, ANPR 13, at 1; Rachide, ANPR 32, at 3; Sibent, ANPR 41, at 1 (and 19 identical ANPR comments). Three franchisees – Raymond Buckley, Roger C. Haines, and David E. Myklebust – believed that they were kept in the dark about the failure of their franchisor's system due to confidentiality clauses imposed on current and former franchisees. Buckley, ANPR 97, at 1; Haines, ANPR 100 at 2; Myklebust, ANPR 101, at 1.

[587] *See* Wieczorek, ANPR, 18Sept97 Tr, at 50.

[588] For that reason, the NPR used the term "gag clause." *See* 64 Fed. Reg. at 57,312-13.

[589] Wieczorek, ANPR, 18Sept97 Tr, at 51; Kaufmann, *id.* at 58-60. *See also* Duvall, 6Nov97 Tr, at 247. Franchisees and their advocates, however, strongly opposed the view that confidentiality clauses are freely negotiated in many instances. They contended that franchisees who are being terminated or seek to resolve a dispute have essentially no choice but to sign a confidentiality clause. Either they sign, or risk losing their investment. *E.g.,* AFA, ANPR Comment 62, at 3. For example, each of the franchisees noted above who described their experiences with confidentiality clauses stated that they believed that they had no choice but to sign.

addressed the confidentiality clause issue, the majority opposing their use.[590] In addition, several participants at the staff's six ANPR public workshop conferences identified confidentiality provisions as a problem. The most poignant example was Marge Lundquist, a franchisee of an undisclosed franchise system, who attended the Chicago conference. She told us that she had to speak quickly because she was on her way to sign a final agreement terminating her relationship with her franchisor. The agreement she was about to sign included a confidentiality clause. Ms. Lundquist stated:

> I am at this point not going to state the franchise because I am on my way at 1:00 to sign the final divorce papers, as such, the papers that separate us legally. There's a gag order there. So, if you are planning on putting this on the Internet, that could be a problem. . . [T]he gag order . . . prohibits me from being able to answer questions, you know, and give cautionary remarks to other people who might be considering the franchise that I was with.

Lundquist, ANPR, 22Aug97 Tr, at 42-43.[591]

Other opponents of confidentiality clauses – including state regulators and some franchisors – asserted that such provisions inhibit prospective franchisees from learning the truth as they conduct their due diligence investigation. As noted above, current and former franchisees are often a valuable source of information about the franchise investment and can often verify or discredit the franchisor's claims, especially financial performance representations.[592] Attempts to

---

[590] *E.g.,* Manuszak, ANPR 13; Paquet, ANPR 18; Rachide, ANPR 32; Sibent, ANPR 41 (and 19 identical ANPR commenters); AFA, ANPR 62, at 3; Buckley, ANPR 97; Marks, ANPR 107, at 2; NASAA, ANPR 120, at 4; Dady & Garner, ANPR 127, at 2; Karp, ANPR, 19Sept97 Tr, at 95. Opponents included several franchisor representatives. *E.g.,* Kestenbaum, ANPR 40, at 2. Cendant opposed the use of confidentiality clauses, except to protect trade secrets or other proprietary information. Cendant, ANPR 140, at 3.

[591] Similarly, Teresa Maloney, a 7-Eleven franchisee, stated:

> When it became apparent to both me and Southland Corporation that it was time to terminate our business relationship, we began negotiating my exit from the system. We came to a mutually acceptable agreement, however, the agreement contained a confidentiality clause. Even if my name appears in a UFOC as a former Franchisee, how much help can I give to anyone asking a question?

Maloney, ANPR 38, at 2.

[592] The National Consumers League, for example, stated: "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

restrict franchisee speech through confidentiality provisions may deceive prospects by effectively eliminating one crucial source of information, namely those current and former franchisees who may have a dispute with the franchisor or are otherwise disgruntled.[593] Indeed, a franchisor, if it wished to do so, could attempt to use confidentiality provisions to ensure that prospects speak with only those franchisees who are successful or otherwise inclined to give a positive report.[594] In addition, one commenter, Andrew Selden, a franchisee representative, contended that the harm flowing from confidentiality provisions goes beyond individual franchise sales, noting that such provisions intimidate franchisees into not testifying before legislative committees and public agencies, such as the Federal Trade Commission.[595]

On the other hand, several franchisors and their representatives opposed banning the use of confidentiality clauses. For example, David Kaufmann stated that confidentiality provisions prevent disgruntled franchisees from inflaming others and enable franchisors to end bad relationships with problem franchisees without spending considerable resources. He contended that banning confidentiality provisions would discourage informal settlements with franchisees.[596] Others added that franchisors must have the ability to protect their trade secrets from disclosure.[597]

---

experience with others should be prohibited." NCL, ANPR 35, at 3. *See also* Baer, ANPR 25, at 3; Karp, ANPR, 19Sept97 Tr, at 95-96.

[593] For example, Roger Haines, a Scorecard Plus franchisee, told us:

> 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, ANPR 100, at 2. *See also* Cantone, ANPR, 18Sept97 Tr, at 50 ("[T]he whole concept of a gag order is really destructive and . . . needs to be addressed.").

[594] *See* NASAA, ANPR 120, at 4.

[595] Selden, ANPR 133, Appendix B. The staff has also found that current and former franchisees may be reluctant to cooperate in an investigation because they have signed an agreement containing a confidentiality clause.

[596] *E.g.,* Kaufmann, ANPR 33, at 5-6; Tifford, ANPR 78, at 3; IFA, ANPR 82, at 2; Duvall, ANPR, 6Nov97 Tr, at 247; Gitterman, *id.*, at 250-51.

[597] *E.g.*, Baer, ANPR 25, at 3. Franchisee advocates also recognized franchisor's legitimate need for trademark protection. *E.g.,* AFA, ANPR 62, at 3; Dady & Garner, ANPR 127, at 2;

Several commenters offered a variety of suggestions on how the Commission might address the use of confidentiality clauses short of an outright ban. For example, a few commenters suggested that the Commission require franchisors to note which of the current and former franchisees listed in their Item 20 disclosures are subject to a confidentiality provision. Such a requirement would accomplish two goals simultaneously. It would alert prospective franchisees that the franchisor may require franchisees to sign a confidentiality provision and would save prospects the time and trouble of trying to contact franchisees who are not free to speak.[598] In response, however, Dennis Wieczorek insisted that this approach would be unnecessarily burdensome: franchisors would have to update their disclosures more frequently, especially in franchise registration states.[599]

Of the various proposals suggested in response to the ANPR, a general disclosure about the use of confidentiality provisions garnered the most support. For example, Zarco & Pardo stated:

> We suggest that the company's policy and use of gag rules should be disclosed, as well as the current percentages regarding their use, i.e., 50% of our non-renewed franchisees in the year 1997 were prohibited from discussing their relationship with the Franchise Co. If franchisors know that they will be required to disclose their percentages in this way, the company may well rethink its policy of requiring gag rules as a matter of course. Potential franchisees, in turn, will be alerted to the potential problems in a system that forbids *any* or a substantial percentage of its former franchisees from speaking about their experience with the company.

Zarco & Pardo, ANPR 134, at 4.[600]

Zarco & Pardo, ANPR 134, at 4. In the NPR, the Commission agreed. For that reason, the NPR's proposed definition of "gag clause" specifically excluded confidentiality agreements to protect trademark and other proprietary information.

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

[599] Wieczorek, ANPR, 6Nov97 Tr, at 258-59. Presumably, franchisors also would have to maintain records on each individual franchisee subject to a confidentiality clause provision. In addition, a requirement that franchisors note which specific franchisees are subject to a confidentiality clause may have the unintended consequence of actually encouraging franchisors to eliminate from their list of 100 franchisees those who are subject to confidentiality clauses, thereby leaving a biased list of only those franchisees who are most successful or satisfied with the system.

[600] *See also* Selden, ANPR 133, Appendix B; Jeffers, ANPR, 6Nov97 Tr, at 251-52; Wieczorek, ANPR, 6Nov97 Tr, at 260.

Similarly Howard Bundy told us that "[i]n a perfect world I would have a list of those that are subject to [confidentiality provisions], 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, ANPR, 6Nov97 Tr, at 249.

Based upon the ANPR comments, the Commission proposed in the NPR a modest new disclosure to address confidentiality clauses.[601] Specifically, if a franchisee signed a contract containing a confidentiality clause in the last three fiscal years, then the franchisor would state in its Item 20 disclosure: "In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experiences 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."[602] In addition, franchisors may, at their own discretion, disclose the number and percentage of current and former franchisees who have signed confidentiality provisions and the circumstances under which such provisions were signed.[603]

The NPR comments on the confidentiality clause issue ran the gamut between those who would ban such clauses to those who urged the Commission to drop the proposal altogether. The IL AG favored an out-right ban on non-proprietary confidentiality provisions. "The ability of a prospective franchisee to freely discuss a present or former franchisee's experience with the franchisor may be the single most important step in a buyer's due diligence investment evaluation." IL AG, Comment 3, at 3.[604] Some franchisee advocates, such as the NFA, generally supported the NPR proposal,[605] while others would strengthen the proposal.[606] Seth Stadfeld, for example, would add a warning, putting prospects on notice that "important adverse information

---

[601] 64 Fed. Reg. at 57,312-23. As noted above, the term "confidentiality provision" would be defined 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 franchisors' trademarks or proprietary information."

[602] *Id.* at 57,344. *See* Bundy, ANPR, 6Nov97 Tr, at 257 (arguing in favor of data for more than one year in order to show any trends).

[603] 64 Fed. Reg. at 57,344.

[604] *See also* IL AG Rebuttal, Comment 38, at 3.

[605] NFA, Comment 27, at 1. *See also* AFA, Comment 14, at 3; Bundy, Comment 18, at 3; Stadfeld, Comment 23, at 5; Karp, Comment 24, at 21-22.

[606] Several commenters also urged the Commission to stress that franchisors must disclose litigation and settlements in Item 3, regardless of the presence of any confidentiality clauses. IL AG, Comment 3, at 4; Stadfeld, Comment 23, at 5;

is being held back from them willfully." Stadfeld, Comment 23, at 6. The AFA and Stadfeld would also require franchisors to identify which franchisees are subject to a confidentiality provision.[607] Mr. Stadfeld also opposed the three year limit; he would favor a 10 year reporting requirement.[608] The AFA also urged the Commission to address confidentiality clauses in Item 17, which addresses terminations and renewals. In its view, franchisors should include in Item 17 a statement such as:

> Upon expiration/termination/non-renewal of your franchise we may [will] require that you sign a confidentiality statement agreeing not to talk about your experience in the [name of] franchise system, whether positive or negative, with anyone outside of the [name of] franchise system including the public, the media or the government.

AFA, Comment 14, at 3.[609]

In contrast, franchisors and their representatives either opposed the proposed confidentiality clause disclosure as unnecessary, or they would narrow it.[610] J&G, for example, insisted that the proposed disclosure is "offensive." J&G, Comment 32, at 14.[611] Others do not go that far. PMR&W, for example, "acknowledge[s] the FTC's concern about prospects being unable to raise questions with current or former franchisees who are subject to confidentiality requirements. The FTC's position is particularly understandable if a gag clause prevents *all*

---

[607] AFA, Comment 14, at 3; Stadfeld, Comment 23, at 6. *But see* GPM Rebuttal, Comment 40, at 7 (opposing release of names).

[608] Stadfeld, Comment 23, at 6.

[609] The AFA also stressed that confidentiality clauses "typically release the franchisor from legal liability and bar the franchisee (under threat of legal action) from making any oral or written statements about the franchise system or their experience with the franchised business. The purpose of such clauses is to shut down any negative public comment about the franchise system." AFA, Comment 14, at 3.

[610] *E.g.,* Quizno's, Comment 1, at 2; H&H, Comment 9, at 20; Baer, Comment 11, at 14; NaturaLawn, Comment 26, at 2; Marriott, Comment 35, at 16. *See also* Snap-On, Comment 16, at 4 (urging the Commission either to not adopt the proposed disclosure or to revise it in a manner to accommodate franchisors' interests in fostering early and amicable settlements). *But see* Bundy Rebuttal, Comment 29, at 2-3 (proposal would not discourage settling disputes).

[611] J&G explained further that the Rule's disclosures already shed light on the franchise relationship. "If efforts at obtaining additional information are unsuccessful because of confidentiality agreements, a reasonable prospective franchisee should be able to take that fact into its evaluation of whether to buy the franchise. And additional disclosure about 'gag clauses' is not helpful." J&G, Comment 32, at 14.

franchisee communication about the franchise system." PMR&W, Comment 4, at 15. Rather, the firm urged the Commission to limit the disclosure's application to only broad "non-communication on any subject" prohibitions. *Id*.

In a similar vein, BI would limit the disclosure to confidentiality clauses in franchise agreements and other contracts signed in connection with the grant of a franchise, but would exclude settlement agreements.[612] The NFC advised that the disclosure should apply "where either all franchisees, or at least twenty percent of the franchisee population, is barred from communicating with third parties." NFC, Comment 12, at 33.[613] Tricon raised a different possible limitation. It noted that when a franchisor buys back a franchised unit, it may wish to include a confidentiality clause relating to the purchase price. It urged the Commission to exclude such details from the disclosure if the franchisee is otherwise free to discuss his or her personal experience as a franchisee.[614]

Finally, H&H opposed the three-year disclosure requirement. In its view, most prospective franchisees would want to know the extent of confidentiality provisions within the last fiscal year. "The fact that two or three years prior thereto franchisees or former franchisees may have been subject to a gag clause would appear to be irrelevant to a prospective franchisee." H&H, Comment 9, at 20.

Based upon the record, it appears that franchisees often sign post-sale agreements containing confidentiality clauses in connection with dispute settlements and terminations. We are convinced that this practice may impede prospective franchisees' ability to conduct due diligence investigations of franchise offerings, undercutting the primary goal of pre-sale disclosure. We believe that the NPR's approach appropriately addresses this issue. Accordingly, we recommend that the Commission adopt the confidentiality clause disclosure set forth in the NPR.

As an initial matter, we reject the extreme positions that the Commission should ban confidentiality clauses, on the one hand, or eliminate the proposed disclosure, on the other. The record does not support an outright ban on confidentiality clauses. Clearly there are instances

---

[612] BI, Comment 28, at 13.

[613] *See* Bundy, ANPR, 6Nov97 Tr, at 249 and Jeffers, *id*, at 251-52 (arguing in favor of a threshold).

[614] Tricon, Comment 34, at 3. *See also* Quizno's, Comment 1, at 2; Marriott, Comment 35, at 16. Marriott asserted that the disclosure will create a disincentive for franchisors to accommodate franchisees' needs in non-standard deals. It noted that franchisors "make a variety of concessions to franchisees in connection with workouts or in connection with sales, or purchasing or conversion of multiple units, among others, in exchange for which the franchisor will request the terms of such arrangements to be kept confidential." *Id*.

where both franchisors and franchisees enter into such clauses voluntarily. As Marriott noted, franchisees in contract modification negotiations may seek or at least agree to confidentiality in order to gain certain advantages. Under the circumstances, we cannot conclude that any potential harm to prospective franchisees from confidentiality clauses necessarily outweighs the potential benefits to franchisees.

At the same time, the compliance burden imposed by the new confidentiality clause disclosure is likely to be minimal. Other than the required statement explaining the nature of confidentiality clauses to prospects who may be unfamiliar with their use, any other disclosures – such as number and percentage or the reasons for the clauses – are entirely voluntary. Moreover, we are unpersuaded that this proposal would discourage settlements. Franchisors opting to pursue litigation in lieu of settlement in order to avoid the confidentiality disclosure would most likely have to disclose even more revealing information about the suit in their Item 3 disclosure.

We also reject most commenters' suggestions either to expand or to narrow the proposed confidentiality clause disclosure. For example, we reject the suggestion that franchisors identify individual franchisees who have signed confidentiality clauses. No doubt, this would make prospective franchisee's due diligence investigation more efficient. However, we believe it would create an enormous burden on those franchise systems that list all of their franchisees in Item 20 on a national basis. It might also require more frequent updating of Item 20 disclosures than is warranted.

We further reject suggestions that the proposed disclosure be limited to only those circumstances where franchisees have signed broad provisions restricting all speech or where a threshold level of franchisees have signed confidentiality clauses. If the purpose of the proposed disclosure were primarily to shed light on the extent of problems in the franchise relationship, then we might agree. As noted above, however, the proposal aims to make prospective franchisees aware of the use of confidentiality clauses. Armed with such knowledge, prospective franchisees would understand that: (1) a refusal by one or more existing franchisees to speak is not necessarily benign; and (2) that the sample of franchisees listed in the disclosure document could actually be skewed. These aims would apply regardless of the scope of the speech restriction used by the franchisor or the number of franchisees subject to such restrictions. More important, adopting a threshold would not address the use of confidentiality clauses to restrict speech by a minority of franchisees (such as franchisees located in a particular city), which might be the most relevant universe of existing franchisees to an individual prospective franchisee.

Nonetheless, we agree that the proposal should not reach confidentiality clauses addressing specific contract negotiation terms and conditions. We recognize that there may be instances where both franchisors and franchisee may not wish to discuss specific terms of an arrangement, such as the price paid for a franchise, or other concessions made to a franchisee. The proposed confidentiality clause disclosure would be unwarranted, therefore, where the parties agree to a limited restriction that still enables franchisees to discuss their overall

experience in the franchise system.[615] While we believe that the proposed definition of confidentiality clause discussed above is sufficient to limit the proposed disclosure's scope, we recommend additional clarification in the Compliance Guides.

c. Franchisee associations

During the ANPR proceeding, several franchisees and their advocates urged the Commission to require franchisors to disclose the existence of trademark-specific franchisee organizations.[616] For example, Andrew Selden stated:

> 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, ANPR 133, Appendix B. at 1. Similarly, Martin Cordell, a franchise examiner for the State of Washington, observed 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

---

[615] The extent to which franchisors must disclose confidential settlement terms and conditions is spelled out in Item 3.

[616] The growth of system franchisee organizations is a recent development. In some instances, these organizations are franchisor sponsored or approved councils, where franchisee-participants are either selected by the franchisor or are elected by franchisees themselves. In other instances, the organizations are independent of the franchisor. The emergence of independent franchisee organizations is not always well-received by the franchisor. 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, ANPR 14 (noting pending federal lawsuit alleging franchisor interference with franchisees' right to form organizations). *Cf.* Mueller, ANPR 29 ("The FTC should take actions against franchisors who intimidate or retaliate against franchisees for getting together for any legitimate business purpose."); Rachide, ANPR 32, at 3 ("[The FTC should prohibit [t]he use of retaliation against franchisees involved in franchisee organizations that work to educate or rally the franchise group."). A few states, including California, Illinois, and Washington have addressed this issue by specifically prohibiting franchisors from restricting franchisees from freely associating or joining franchisee organizations. *See* Cal. Corp. Code § 31220; 815 Ill. Comp. Stat. 705/17; Wash. Rev. Code 19.100.180(2)(a).

businesses to share information with the prospective franchisee." Cordell, ANPR, 6Nov97 Tr, at 168-69. Susan Kezios of the AFA added that these 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.

Franchisors' reaction to the proposed disclosure was mixed. Some did not oppose a disclosure for trademark-specific franchisee organizations, especially franchisor-sponsored franchisee advisory councils or endorsed independent franchisee organizations. However, they voiced concern about any mandate to disclose all independent franchisee organizations. In their view, independent organizations are often small, informal groups of individual franchisees that may come and go at any time, or are often formed on the local or regional level without the knowledge or involvement of the franchisor.[617] In short, they fear liability for failing to disclose a franchisee organization that they did not know exists.[618]

In the NPR, the Commission tentatively adopted the trademark-specific franchisee association disclosure. The Commission stated that such a disclosure would give franchisees an additional source of material information from which they could learn about the system. The Commission added that this disclosure is "particularly important if individual former and existing franchisees . . . are subject to a [confidentiality] clause or are otherwise reluctant to talk with a prospective franchisee." 64 Fed. Reg. at 57,314. The Commission also addressed franchisors concerns about informal or unrepresentative groups of franchisees by proposing that only incorporated, independent trademark-specific associations need be disclosed and only to the extent such organizations make their existence known to the franchisor on an annual basis.[619]

In response to the NPR, franchisees and their advocates unanimously supported the proposal.[620] Seth Stadfeld, however, questioned why the proposed disclosure of independent trademark associations should be limited to "incorporated" associations. In his view, all such associations should be disclosed, whether incorporated or not. Mr. Stadfeld proposed that it should be enough that the group represent a significant segment of the franchisee population,

---

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

[618] Wieczorek, ANPR, 18Sept97 Tr, at 74.

[619] 64 Fed. Reg. at 57,314.

[620] *See e.g.,* AFA, Comment 14, at 5; NFA, Comment 27,at 2; Stadfeld, Comment 23, at 14; Karp, Comment 24, at 9; Bundy, ANPR, 6Nov97 Tr, at 173; Manuszak, ANPR 13; Zarco & Pardo, ANPR 134, at 3. Eric Karp also asserted that franchisors generally are hostile to independent trademark franchisee organizations, implying that franchisors ordinarily would not disclose their existence voluntarily. *See* Karp, Comment 24, at Appendix A (listing cases involving franchisee organizations).

such as 25%.[621] The IL AG offered an opposing view, however, asserting that the benefits of this disclosure may be lost if the Commission imposed a threshold:

> While trying to design a workable association rule, please consider the mindset of most franchisees, which is an extreme fear of retaliation for belonging to an association not sponsored by the franchisor. Even in systems where this fear is unjustified, franchisees are still afraid to be identified with people or groups that may from time to time oppose policies of the franchisor. Setting a minimum percentage of franchisees to be a qualified association is virtually unworkable, but if this approach is used the threshold should be set very low. Five percent of a system's franchisees who are willing to be known as members of a franchisee association may be accompanied by 25% of the franchisees that are of like mind, but afraid to reveal their membership.

IL AG Rebuttal, Comment 38, at 4.

On the other hand, franchisors and their advocates generally opposed the disclosure of independent trademark-specific franchisee associations.[622] For example, the NFC maintained that the required list of franchisees is enough to determine the state of franchise relations in the system. "The due diligence short-cut proposed in the NPR could lead to the dissemination of misinformation by non-representative groups with narrow agendas and turn franchisors' offering circulars into political footballs." NFC, Comment 12, at 33. H&H feared that franchisee rights advocates will simply "incorporate an organization to promote their anti-franchisor agenda to prospective franchisees." H&H, Comment 9, at 20-21.[623] These and other commenters cautioned that the disclosure may create the false illusion that each and every disclosed organization is representative of the body of franchisees, when in fact such groups may represent only a few franchisees.[624]

Several franchisor representatives urged the Commission to restrict the proposed disclosure further to ensure that the organizations disclosed will be fairly representative of the franchisees in the system. For example, BI stated the proposed disclosure would include "every incorporated franchisee organization requesting it, no matter how many such organizations exist and have requested inclusion, and no matter how few franchisees may actually be members of any such organization." BI, Comment 28, at 13. J&G would require that the association be

---

[621] Stadfeld, Comment 23, at 14-15.

[622] *E.g.,* Baer, Comment 11, at 14.

[623] *See also* NFC, Comment 12, at 32-33.

[624] *See* PMR&W, Comment 4, at 15.

comprised of a substantial number of franchisees[625] and meet or communicate with the franchisor at least twice annually for the purpose of addressing franchise relationship issues. Further, the firm would require the association to:

> provide written notice to the franchisor no later than 30 days after the close of the franchisor's fiscal year end identifying the organization, its mission, its form of organization and the number of franchisees and franchised units which are dues-paying members or otherwise accredited members of the organization. If some franchisees are not dues-paying members, standards used for accreditation should be enclosed in the notice.

J&G, Comment 32, at 13.[626]

Finally, several commenters offered various suggestions to improve the proposed disclosure. In the NPR, the Commission proposed that the trademark association disclosure include those associations that have been "created, supported, or recognized by the franchisor." 64 Fed Reg. at 57,344. BI, among other commenters, stated that the term "recognized" is ambiguous and should be clarified.[627] Similarly, the IL AG recommended that the Commission specifically define the term "trademark-specific franchisee association."[628] Seth Stadfeld would have franchisors disclose, where possible, the name, address, and telephone number of the organization and those of its officers, if known.[629] Eric Karp would require the disclosure of the trade organization's fax number, email address, and Internet home page, if provided by the association.[630] He also advised the Commission to clearly state that the request for inclusion

---

[625] *See also* H&H, Comment 9, at 21 (if the organization represents 30% of franchisees); NFC, Comment 12, at 33 (if the organization represents 20% of the franchisees); Stadfeld, Comment 23, at 14-15 (if the organization represents 25% of franchisees); BI, Comment 28, at 13 (unspecified threshold).

[626] *See also* PMR&W, Comment 4, at 15; Marriott, Comment 35, at 16. *But see* Karp, Comment 24, at 10 (The Rule should require franchisor to accept the representation of the organization that it is incorporated and may not require any collateral document.).

[627] BI, Comment 28, at 7. *See also* J&G, Comment 32, at 12-13; Marriott, Comment 35, at 16.

[628] IL AG, Comment 3, at 9.

[629] Stadfeld, Comment 23, at 14.

[630] Karp, Comment 24, at 9. *See also* AFA, Comment 14, at 5 (franchisors should disclose the name of independent franchisee organizations affiliated with the chain, the contact person's name, address, and telephone, facsimile and email numbers).

must be renewed on an annual basis within 90 days prior to the anniversary of each 12-month period.

Based upon the record, the staff recommends that the Commission retain the proposed trademark-specific association disclosure.[631] We are persuaded that the proposed trademark-specific franchisee association disclosure would advance two important goals: it would provide prospective franchisees with an additional source of information from which they could verify the franchisor's claims, and it would shed light on the quality of the franchise relationship. As the Commission noted in the NPR, the names and addresses of current franchisees is material information, enabling prospective franchisees to conduct their own due diligence investigation of the franchise system. In addition, the staff often advises prospective franchisees to contact as many existing franchisees as possible to verify the franchisor's claims and to seek additional information about the franchisor and its system.[632] Providing information about an organized group of franchisees fits squarely within this advice.

We also note that proposed Item 20 requires franchisors to disclose the names and addresses of only a limited number of franchisees in their systems. Franchisors need not disclose more than 100 franchisees. This is true even for medium and large franchise systems with several hundred, if not several thousand, franchisees. Therefore, it is possible for some franchisors to hand-select franchisees listed in their disclosure documents, revealing only successful franchisees who maintain a good relationship with their franchisor.[633] Moreover, a franchisor could use confidentiality clauses to achieve the same goal. Therefore, the Item 20 list of franchisees may not be a random sample or otherwise representative of franchisees within a particular system. One approach to counter any franchisor-bias is to require that franchisors disclose the existence of franchisee organizations, providing prospective franchisees with an alternative view of the franchise system.

There is also evidence in the record that individual franchisees often are reluctant to share information 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." Bundy, ANPR, 6Nov97 Tr, at 236-37.[634] In

---

[631] Franchisors would disclose the name, address, telephone number, and email address of the association, and state if the association is franchisor-sponsored.

[632] *See, e.g., A Consumer Guide To Buying A Franchise,* at 16-17.

[633] While 100 franchisees may know about franchisor-sponsored associations, they would not necessarily know about independent associations, in particular those in particular locations, or about associations for specific-use franchisee groups (e.g., those operating kiosks in malls).

[634] *See, e.g.,* Hayden, RR 42; Spencer, RR, Sept95 Tr, at 74.

his view, 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. Franchisees who volunteer information also might be subject to a defamation suit by the franchisor.[635] The proposed trademark-specific franchisee association disclosure, therefore, would be an important alternative source of information, especially if numerous individual former and existing franchisees of a system are subject to confidentiality clauses.

There is also evidence in the record that franchisors do not readily inform prospects about the existence of independent organizations. For example, at the sixth public workshop conference, Michael W. Chiodo, the executive director of the Domino's Franchisee Organization, explained that Domino's does not inform franchisees about the existence of the Organization, nor does Domino's inform the Organization about new franchisees.[636]

Finally, a franchisee association disclosure is particularly important if, as the staff recommends, the Commission does not mandate financial performance disclosures. One rationale for not mandating performance information is that prospects can contact franchisees directly to obtain such information. Indeed, franchisees are the best source of information about their own earnings. If true, then prospective franchisees, at the very least, should be able to contact as many existing and former franchisees as possible. A franchisee association disclosure may greatly assist prospective franchisees in their due diligence investigation of franchisees' financial performance by providing an independent source of information.

In reaching our conclusion, we are mindful of the view that the proposed disclosure is overly broad and burdensome. The proposal, however, requires franchisors to disclose only those organizations whose existence is actually known to them. It requires no special research or recordkeeping on a franchisor's part. In particular, franchisors are to disclose the existence of independent associations on an annual basis only and then only if that the association renews its request for inclusion in the disclosure document in a timely manner. We believe these limitations will reduce franchisor's compliance burdens and potential liabilities.

We also recognize that the proposal may result in the disclosure of associations that are not necessarily representative of franchisees as a whole. However, we believe there is value in enabling prospective franchisees to speak with an association representing similar interests, even if not representative of the entire system. For example, a small association of franchisees in Anchorage, Alaska, might provide prospective franchisees with valuable information about local labor costs, financial performance data, as well as information about third-party suppliers. For this reason, we reject the notion that an independent organization should be forced to establish that they represent a specific percentage of franchisees in a system.

---

[635] Bundy, ANPR, 6Nov97 Tr, at 237.

[636] Chiodo, ANPR, 21Nov97 Tr, at 294-95. *See also* Galloway, *id*. at 317-18. *See also* Manuszak, ANPR 13.

Nonetheless, we believe some limitation on independent associations is warranted. Accordingly, we recommend that, at the very least, the association be incorporated. The proposed incorporation requirement would exclude unorganized groups of isolated franchisees, while increasing the odds that relevant associations with an institutional history, structure, and willingness to discuss issues with prospects will be included. We also believe it is proper to permit franchisors to include a disclaimer, if they wish. The disclaimer would read: "The following independent franchisee organizations have asked to be included in this disclosure document. We do not endorse these organizations and their members may not represent all franchisees in the [name of franchisor] franchise system." We believe the proposed incorporation limitation coupled with the proposed voluntary disclaimer strikes the right balance between pre-sale disclosure and compliance burdens.

Finally, we recommend that the Commission revise the proposed trademark-specific franchisee association disclosure to incorporate several commenters' suggestions. First, we recommend that the Commission use the term "sponsored or endorsed" association, rather than the arguably ambiguous term "recognized" association. Second, we would clarify the time period in which independent associations can seek inclusion in a franchisor's disclosure document, making explicit that requests must be renewed annually and within 90 days after the close of the franchisor's fiscal year. As noted above, we recommend that the Commission extend the annual update period to 120 days[637] A 90-day franchisee association renewal period would afford franchisors sufficient time to prepare the disclosure before the expiration of the 120-day annual update period. We also believe that email and web page addresses should be provided for all disclosed associations, if known. As with the cover page, this information will assist prospective franchisees in contacting the organization before and after the franchise sale.

So revised, the proposed trademark-specific franchisee association disclosure would read as follows:

> (8) Disclose the name, address, telephone number, email address, and Web address, to the extent known, of each trademark-specific franchisee organization associated with the franchise system being offered, if such organization:
> (i) Has been created, sponsored, or endorsed 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. Such organizations must renew their request for inclusion in the disclosure document annually and within 90 days after the close of the franchisor's fiscal year. The franchisor has no obligation to verify the organization's continued existence at the end of each fiscal year. Franchisors may also include the following statement: "The following independent franchisee associations have asked to be included in this disclosure document. We do not endorse these organizations and their members may not represent all franchisees in the [name of franchisor] franchise system."

---

[637] *See* below at section VIII.B.1.

W. Proposed Section 436.5(u)
Item 21: Financial Statements

1. Background

Proposed Item 21 of the NPR would require franchisors to disclose three years of audited financial information based upon generally accepted accounting principles.[638] It would improve the current Rule provision[639] by incorporating the UFOC Guidelines' requirement that financial disclosures be in a tabular format that compares at least two fiscal years. This provides prospective franchisee's with information with which to assess financial trends, rather than just an isolated snap-shot of the franchisor's finances. As proposed in the NPR, however, Item 21 would differ from UFOC Item 21 in two respects. First, consistent with other provisions of the proposed revised Rule, it would require the disclosure of a parent's financial information. Second, it would retain the Commission's long-standing policy of permitting franchisors to phase-in audited financial statements over three years.[640]

2. The record and recommendations

a. Parent financial information

In the NPR, the Commission proposed that Item 21 require franchisors to disclose a parent's financial information.[641] As with other sections of the proposed Rule, several commenters questioned the routine inclusion of parent information. For example, PMR&W observed that the UFOC Guidelines specify only that state examiners may ask for audited financials of a parent, but the Guidelines do not mandate it. In its view, parent financial

---

[638] 64 Fed. Reg. at 57,315. In the SBP, the Commission noted that a franchisee is purchasing, "along with the franchise itself, some assurance of the financial stability of the franchisor, of the franchisor's ultimate ability to meet its obligations to its franchisees." 43 Fed. Reg. at 59,679. For that reason, the Commission concluded that the disclosure of basic financial information by all franchisors "is essential."

[639] 16 C.F.R. § 436.1(a)(20).

[640] "Without the auditing requirement, the financial statements remain nothing more than the franchisor's own representation of its financial condition." 43 Fed. Reg. at 59,679-80. Nonetheless, the costs associated with preparing audited financial statements might create a barrier to entry by start-up franchisors. In the SBP, the Commission made it clear that, as a matter of policy, franchisors can use unaudited financials during a phase-in period. *Id.* at 59,681.

[641] 64 Fed. Reg. at 57,315.

statements are not relevant and are rarely requested.[642] Warren Lewis suggested that the Commission require the disclosure of parent financial statements "only if (i) the company with the control chooses to guarantee the obligations of the franchisor or subfranchisor to the franchisee in writing, and (ii) a copy of the written guarantee is included in Item 21 or an exhibit." Lewis, Comment 15, at 18.[643] In a similar vein, H&H and Warren Lewis opined that it is unnecessary to require routine financial statements of subfranchisors: financial statements should be provided only by the entity with whom the franchisee will have a contractual relationship.[644]

Consistent with our view expressed in other sections of this Report, we believe that parents should not have to disclose financial information in all instances. Rather, we recommend that Item 21 compel the disclosure of a parent's financial information only in two circumstances: where the parent: (1) commits to perform post-sale obligations for the franchisor; or (2) guarantees obligations of the franchisor. On the other hand, we recommend that the Commission require subfranchisors to furnish financial disclosures in all instances.[645] As noted in our discussion of the term "franchisor" above, the term "subfranchisor" is limited to circumstances where the subfranchisor steps into the shoes of the franchisor by selling and performing post-sale obligations. It does not reach those individuals who act like brokers, without any post-sale commitments. Where a person – be it subfranchisor or parent, as previously noted – commits to perform under the franchise agreement, their financial information becomes material in order to provide prospective franchisees with the opportunity to assess the person's financial stability before risking their own investment.

Finally, we recommend that Item 21 require franchisors to attach a copy of any guarantee in their disclosures. Although the UFOC Guidelines are less than clear on this point, we believe

---

[642] PMR&W, Comment 4, at 16. *See also* Lewis, Comment 15, at 18; Snap-On, Comment 16, at 4; PREA, Comment 20, at 2; Marriott, Comment 35, at 17. Similarly, J&G opposed consolidated financial statements of affiliates where the franchisor has included its own financial statements. "The increased cost and potential liability of other affiliates is unwarranted." J&G, Comment 32, at 13.

[643] *See also* Baer, Comment 11, at 5; IL AG Rebuttal, Comment 38, at 4. In the same vein, Howard Bundy suggested that a franchisor should be permitted to use an affiliate's financial statements only "if the affiliate guarantees *all* of the duties and obligations of the franchisor *in writing* and *for the entire* term of the franchise, including any renewals and extensions" and a copy of the written guarantee is included in the disclosure document. Bundy, Comment 18, at 11 (emphasis in original).

[644] H&H, Comment 9, at 21, Lewis, Comment 15, at 17.

[645] This differs from the UFOC Guidelines approach, which requires subfranchisor financial statements only when the subfranchisor is the applicant for franchise registration.

that Instruction v. contemplates such a disclosure. Moreover, it is sound policy. Before a prospective franchisee is asked to invest in a franchise, it should be able to assess the extent of any performance or financial guarantees by a parent or subfranchisor.

So revised, proposed Item 21 would read: "Include separate financial statements for the franchisor, subfranchisor, and any parent or other entity that commits to perform post sale obligations for the franchisor or guarantees the franchisor's obligation. Attach a copy of any guarantee to the disclosure document."

b. Audited financial statements

The current Rule and UFOC Guidelines require franchisors to make audited financial disclosures prepared according to generally accepted accounting principles ("GAAP") and auditing standards by an independent certified or licensed public accountant.[646] In the NPR, the Commission proposed retaining the GAAP requirement.[647] At the same time, the NPR added clarity by referring to "GAAP" as "generally accepted *United States* accounting principles." *Id.* at 57,344.[648]

In response to the NPR, a few commenters opposed the required use of U.S. GAAP by foreign franchisors. These commenters observed that this requirement would impose expenses and burdens on foreign corporations entering the American market. H&H's comment is typical: "For companies located in many foreign countries, . . . a requirement to convert to US accounting standards would be enormously expensive." H&H, Comment 9, at 13.[649] H&H urged the Commission to permit foreign franchisors to prepare financial statement that "conform to U.S. GAAP or otherwise to generally accepted accounting principles established in the country of the company's domicile." *Id.*[650] This view, however, was not universally shared. The IL AG argued

---

[646] 16 C.F.R. § 436.1(a)(20); UFOC Item 21. *See also* 43 Fed. Reg. at 59,680 (without auditing "the financial statements remain nothing more than the franchisor's own representation of its financial condition").

[647] 64 Fed. Reg. at 57,315.

[648] This is entirely consistent with the staff of the Commission's view that the current Rule requires all franchisors – foreign and domestic – to prepare financial statements using U.S. GAAP only. *See generally,* Advisory 02-4, Bus. Franchise Guide (CCH), ¶ 6515 (Nov. 18, 2002).

[649] *See also* NFC, Comment 12, at 33.

[650] Warren Lewis suggested that the Commission permit foreign franchisors to "use financial statements prepared according to their countries' GAAPs, provided that those GAAPs are comparable to US GAAP." Lewis, Comment 15, at 17. Mr. Lewis, however, provided no criteria or examples that would help us determine what GAAP are or are not "comparable."

that foreign companies should follow U.S. GAAP or be permitted to reconcile their financial statements to U.S. GAAP through footnotes and explanations.[651]

NASAA raised a slightly different concern. It observed that the Commission requires GAAP only for audited financial statements. It urged the Commission to apply GAAP to all financial statements, audited or unaudited. "The Project Group suggests that because financial statements are required of all franchisors, those statements should be prepared according to GAAP." NASAA, Comment 17, at 11.

As noted in our discussion above concerning the scope of the Rule, the sale of franchises internationally was not an issue that loomed large when the Commission promulgated the Franchise Rule in the 1970s. We recognize that application of only U.S. GAAP in today's global economy may impede competition from foreign franchisors. Accordingly, we believe a more flexible approach is warranted, especially in the absence of any evidence in the record that financial statements prepared by foreign franchisors to date have been deceptive or misleading.

As an initial matter, there is no question that the primary purpose of a disclosure document is to provide prospective franchisees with material information in a clear and conspicuous manner. Consistent with that principle, franchisors should present financial data in a format that is meaningful to American prospective franchisees, as well as to their advisors. We believe the suggestion offered by IL AG – that foreign franchisors use U.S. GAAP or reconcile their financial statements to U.S. GAAP – adds needed flexibility, while reducing costs and burdens on foreign franchisors. Indeed, this is the very position adopted by the Securities and Exchange Commission ("SEC") for the registration of securities by foreign companies.

The SEC permits foreign companies registering securities to prepare financial statements using accounting procedures other than U.S. GAAP under limited circumstances. The first prerequisite is that such statements be prepared "according to a comprehensive body of accounting principles." The company must also disclose the specific comprehensive body of accounting principles used to prepare the statements and explain material differences between the principles and U.S. GAAP. The company must also reconcile its statements with U.S. GAAP. For example, through additional notes, franchisors must reconcile figures for net income and total shareholders' equity for the period presented. Finally, the statements must provide all additional disclosures required by U.S. GAAP and applicable SEC regulations.[652]

---

[651] IL AG Rebuttal, Comment 38, at 5.

[652] *See* SEC Form 20-F, Part III, Items 17 and 18. The SEC has also made clear that even if a foreign company reconciles its financial statements to U.S. GAAP, it must audit the financials according to U.S. generally accepted auditing standards and the auditor must comply with the U.S. standards for auditor independence. *See Id.*, General Instruction E(c).

We recommend that the Commission accept foreign financials that satisfy the SEC criteria.[653] As a starting point, the SEC standard would ensure against deception by requiring foreign franchisors to establish that their financials are prepared "according to a comprehensive body of accounting principles." Further, it would add flexibility and minimize costs and burdens on foreign franchisors, while ensuring that prospective franchisees receive the same material financial information as they would receive from a domestic franchisor. We believe this flexible approach is warranted especially given the absence of any showing or suggestion in the record that reconciled, foreign financial statements are inherently deceptive or misleading.[654] At the same time, we recognize the possibility exists that American accounting principles are likely to change. Under the circumstances, we recommend that the Commission update Item 21 to ensure that financial statements must be prepared according to U.S. GAAP or as permitted by the SEC, as revised by any future government mandated accounting principles.

c. Phase-in of audited financial statements

During the Rule Review, commenters representing all affected interests urged the Commission to retain the three-year phase-in of audited financial statements for start-up franchise systems. To that end, the Commission solicited in the ANPR additional comment on this issue.[655] All of the commenters who responded urged the Commission to retain the three-year phase-in.[656] No commenter offered any refinements or alternatives to the Commission's current approach.

In the NPR, the Commission tentatively adopted the three-year phase-in, recognizing that new franchise systems may not have three years of financial information with which to make the Item 21 disclosure.[657] Support for the NPR's phase-in proposal, however, was not unanimous. Howard Bundy opposed a phase-in, noting, among other things, that the states do not have a comparable provision. He also cited Small Business Administration statistics showing that only 25% of franchisors survive five years. "If we excuse audited financial statements for the first two

---

[653] We agree with the NASAA that, to prevent fraud, the accounting standard adopted should apply to both audited and unaudited financial statements.

[654] Of course, the Commission retains its Section 5 authority to challenge any deceptive foreign statements prepared according to the SEC standard.

[655] 62 Fed. Reg. at 9,121.

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

[657] 64 Fed. Reg. at 57,315.

years, for all practical purposes, even more investors will risk losing everything." Bundy, Comment 18, at 11.[658]

On the other hand, John Baer not only supported the phase-in, as drafted in the NPR, but went so far as to urge the Commission to make it preemptive: "The Commission should be aware that several of the states require the use of audited opening balance sheets in order to register a start-up franchisor. We believe that this is another example of why the Franchise Rule should preempt inconsistent state law requirements. One set of financials should be acceptable throughout the country." Baer, Comment 11, at 15.

While NASAA supported the proposal generally, it questioned the reference to "start-ups" in the phase-in provision. It noted that: "[i]f a major corporation that has been in business for many years and then begins to franchise, that corporation should not enjoy the same exemption from disclosing audited financial statements as a new company that just organized as a true 'start up' franchise system." NASAA, Comment 17, at 11. The NASAA Project Group suggested that franchisors that have been in any type of business for three years or more, not just the business of selling franchises, should be required to provide audited financial statements. *Id*.

The staff continues to believe that a phase-in of audited financial statements is desirable, for the reasons noted above. Nonetheless, we recommend that the current phase-in be fine-tuned, as proposed in the NPR. The staff often receives inquiries from attorneys attempting to make sense of the current phase-in schedule. Under the current phase-in, a franchisor may furnish a balance sheet for "the first full fiscal year following the date on which the franchisor must first comply with [the Rule.]" 16 C.F.R. § 436.1(a)(20)(ii). It is often unclear when the franchisor's first fiscal year ends. For example, a franchisor may have started selling franchises three months into its first fiscal year (e.g., in March 1, 2002, using a calendar fiscal year). At the conclusion of that fiscal year (December 31, 2002), the franchisor would have sold franchises for nine months. Yet, under the current phase-in, the franchisor's first fiscal year would not end until December 31, 2003, because the phase-in uses the language "first *full* fiscal year" after starting to sell franchises. We recommend that the Commission replace the word "full" with "first *partial or full* fiscal year" so that a franchisor's first fiscal year will end consistent with its general accounting practices, regardless of when the franchisor may have started offering franchises within that year.[659] Under this revised approach, the Commission will look to the close of the franchisor's first fiscal year after selling franchises, regardless of whether that time period was a partial or full year. No comments were submitted concerning the NPR's first-year calculation

---

[658] Mr. Bundy also noted that an audit gives a franchisee a potential remedy that otherwise would be unavailable. "[T]here is no doubt that the auditor has liability to the franchisee if the auditor did not follow proper procedures and provide the appropriate warnings – including notes to the effect that the company may not be solvent or may be reliant upon selling more franchises for its economic survival." Bundy, Comment 18, at 11.

[659] *See* 64 Fed. Reg. at 57,315.

proposal. Therefore, we recommend that the Commission adopt the NPR's proposed revised phase-in of audited financial statements in the final revised Rule.

We also find merit in NASAA's comment. The term "start-up" may be overly broad, effectively permitting companies that have prepared audited financial statements to avoid including them in their disclosure documents. Indeed, any franchisor could attempt to avoid disclosing bad financial data by reincorporating and selling franchises under a new name. Nonetheless, we do not recommend further revision of proposed Item 21. Rather, we recommend that the Compliance Guides accompanying the Rule explain the meaning of "start-up," as NASAA suggested. In short, the Compliance Guide will make clear that the audited financial statement phase-in is available only to entities that are new to franchising and that ordinarily have not prepared audited financials statements to date. Any non-franchise company that has prepared audited financials in the ordinary course of business must include such audited financials in its disclosure documents if it decides to begin offering franchises.[660] The phase-in is also not intended for spin-offs, affiliates, or subsidiaries of a franchisor, where the franchisor has been engaged in franchising or has prepared audited financial statements for any other purpose.

X. Proposed Section 436.5(v) Item 22: Contracts

1. Background

Proposed Item 22 of the NPR would adopt the UFOC Guidelines requirement that franchisors attach a copy of all relevant agreements to the disclosure document, such as the franchise agreement, leases, options, or purchase agreements.[661] This is similar to the current Rule requirement that franchisors provide prospective franchisees with copies of relevant documents at least five business days prior to the date of execution.[662] Arguably, proposed Item 22 is not a disclosure item at all, but an instruction on how to prepare a disclosure document. For that reason, the requirement logically could appear in the revised Rule's general instructions section. In an effort to reduce inconsistencies between federal and state law, however, the staff

---

[660] *See* Final Interpretive Guides, 44 Fed. Reg. at 49,981 ("Franchisors may use unaudited financial statements . . . if they lack audited statements for the fiscal years to be reported when they are first required to furnish a basic Disclosure Document.").

[661] 64 Fed. Reg. at 57,315. *See* UFOC Guidelines, Item 22.

[662] *See* 16 C.F.R. § 436.1(g). These attachments would enable prospective franchisees to compare a franchisor's disclosure about the parties' legal obligations with the actual agreements that will govern the franchise relationship. 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 Fed. Reg. at 59,696.

recommends that the Commission follow the UFOC's Guidelines approach of including this requirement among the Rule's disclosure items.

2. The record and recommendations

Only one comment was submitted concerning Item 22. David Gurnick expressed concern that the term "contract" could be misinterpreted to suggest that Item 22 requires the disclosure of post-sale settlement agreements. He suggested that Item 22 expressly state that "the contracts to be attached do not include forms of negotiated settlement agreements," especially since the terms of any such agreements are unknown at the time of sale. Gurnick, Comment 21, at 7.

We suppose it is possible for a franchisor to misread proposed Item 22 as including future settlement negotiations. However, we do not believe this is likely. Item 22 refers to those contracts that involve the franchise offering at the time of the sale. Clearly, franchisors cannot disclose something that may only exist at some future date. Therefore, we do not believe that proposed Item 22 needs to be revised.

Y. Proposed Section 436.5(w) Item 23: Receipt

1. Background

Based upon UFOC Item 23, proposed Item 23 of the NPR would require prospective franchisees to acknowledge receipt of the disclosure document. At the same time, it would afford franchisors and franchisees wider latitude in demonstrating acknowledgment of receipt than the comparable UFOC Guidelines provision.[663] Whereas UFOC Item 23 requires franchisors to acknowledge receipt with a handwritten signature, proposed Item 23 would allow prospective franchisees to acknowledge receipt through a "signature," which, as explained in the definitions above, would include not only written signatures, but electronic signatures, passwords, security codes, and other devices that enable a prospective franchisee to easily acknowledge receipt, confirm his or her identity, and submit the information to the franchisor. Proposed Item 23 would also provide that franchisors may include specific instructions on how to submit the receipt, such as via facsimile.[664] This would enable the parties to determine for themselves the most efficient and cost-effective way for the prospective franchisee to transmit the receipt acknowledgment.

---

[663] 64 Fed. Reg. at 57,344.

[664] *Id*. at 57,315 and 57,344.

2. The record and recommendations

Several commenters supported the proposed receipt requirement. According to IL AG, the receipt page serves as an important reminder to the prospect that he or she is supposed to receive a disclosure document. "If no disclosure document is provided we would hope it would make the franchisee refuse to sign the receipt. . . . [T]he receipt is an extremely important document when a franchisee later alleges that disclosure was never effected." IL AG, Comment 3, at 9. John Baer similarly stated that requiring franchisors to prove receipt is "useful for both franchisors and franchisees." Baer, Comment 11, at 15.

We agree that the proposed receipt requirement benefits both prospective franchisees and franchisors. Like the cover page, the proposed receipt serves an important consumer education function,[665] informing prospects that they have 14 days to review the disclosures, that they should receive certain attachments, and that they can report possible law violations. At the same time, it enables franchisors to provide proof of delivery. This is especially important if, as proposed below, the Commission permits franchisors to furnish disclosures electronically.

Nonetheless, we note that a few commenters suggested that the proposed Item 23 should be fine-tuned. Warren Lewis, for example, advised us that the title of Item 23 should be changed from "receipt" to "receipts," observing that the current industry practices is to have two receipts at the end of the disclosure document, one the franchisee retains as part of the disclosure document and the other returned to the franchisor.[666] He would also change the reference to "franchisee's signature" to the words "prospective franchisee's signature," noting that some prospective franchisees object to signing receipts as "franchisees," since this designation is inaccurate until they have signed the franchise agreement.[667] NASAA also suggested that the Commission clarify that the acknowledgment page must be placed as the last two pages of the disclosure document. In support, it observed that "[t]he States that review franchise offerings have noted may instances where this page was buried in the middle of the disclosure document." NASAA, Comment 17, at 11. We believe these suggestions are sound and recommend that the Commission adopt them.

We also note that H&H would revise the second paragraph. As drafted in the NPR, this paragraph states, in relevant part: "If [name of the franchisor] offers you a franchise, it must

---

[665] Other Commission trade regulation rules contain provisions that serve a similar educational function. *E.g.,* Energy Guides, 16 C.F.R. Part 305, App. L. ("Compare the energy use . . .with others before you buy."); Cooling-Off Rule, 16 C.F.R. § 429.1 (Notice of right to cancel); Used Car Rule, 16 C.F.R. § 455.2 ("Below is a list of some major defects that may occur in used motor vehicles.").

[666] Lewis, Comment 15, at 18.

[667] *Id.*

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]." H&H would modify "binding agreement" to read "binding agreement with the franchisor or any of its affiliates." The firm asserted that the franchisor cannot control whether a prospective franchisee proceeds to commit with independent, third parties before expiration of the 14 day period." H&H, Comment 9, at 21. As noted in our discussion of the disclosure trigger above, [668] we agree, concluding that franchisors must furnish disclosures 14 days before the prospective franchisee makes a payment to, or signs an agreement with, the franchisor or an affiliate.[669] Accordingly, we recommend modifying the proposed receipt as H&H suggested.

Finally, we note that a few commenters addressed a proposal in the NPR that franchisors obtain a signed copy of the Item 23 receipt five days in advance of a prospective franchisee's signing the franchise agreement or payment of a fee in connection with the franchise sale. The Commission proposed this requirement in the NPR to ensure that the prospective franchisee in fact received the disclosures before the franchisor finalized the franchise sale.[670] PMR&W, for example, questioned the need for this provision, asserting that there is no record of abusive practices in this area. According to the firm, as long as the franchisor obtains the receipt and retains it for the necessary recordkeeping period, no other requirement should be imposed.[671] On the other hand, John Baer supported the proposal: "Requiring franchisors to prove that prospective franchisees actually received a disclosure document is useful for both franchisors and prospective franchisees. For the franchisor, it is a consistent reminder of the need to comply with the 14 day disclosure rule." Baer, Comment 11, at 15.

We are persuaded that the proposed five-day period is unnecessary and should be deleted from the final revised Rule. A franchisor always has the burden of proving that it in fact has complied with the Rule's disclosure and timing provisions. We are reluctant, therefore, to impose a new, timing provision. In those instances where franchisors never furnish disclosures -- or furnished incomplete or inaccurate disclosures -- the proposed revised Rule's 14-day trigger and the substantive disclosure obligations are sufficient to address the problem. Moreover, we find that proposed Item 23's general recordkeeping provision obviates the need for a more specific requirement that franchisors obtain a copy of the receipt at least five days in advance of the sale. Further, the Commission proposed a five-day post-receipt waiting period in part because franchisors, under the current Rule, already must wait five days for the prospective franchisee to review the completed franchise agreement. However, as noted above, we

---

[668] *See* section V.B.2.c.

[669] At the same time, we recommend that the Commission prohibit a franchisor from failing to furnish disclosures earlier in the sale process, upon reasonable request.

[670] 64 Fed. Reg. at 57,315.

[671] PMR&W, Comment 4, at 5.

recommend that the five-day review period be deleted from the Rule, except in those instances where the franchisor initiates changes in the basic contract. Because the five-day agreement review period no longer applies as a matter of course in all franchise sales, we are reluctant to recommend retaining the five-day period just for receipts in the absence of evidence showing a widespread problem in this area.

VII. PROPOSED SECTION 436.6: GENERAL INSTRUCTIONS

A. Background

In the NPR, the Commission proposed two new sections that would set forth the basic instructions for preparing a disclosure document. The first section (NPR section 436.6) would set forth general instructions for preparing all disclosure documents. Specifically, the NPR proposed retaining the current Rule's three basic instructions for preparing a disclosure document: (1) that disclosures be prepared clearly, legibly, and concisely in a single document;[672] (2) that franchisors respond affirmatively or negatively to each disclosure item;[673] and (3) that franchisors do not add any materials to a disclosure document, except for information required by non-preempted state law.[674] The proposed instructions would also adopt the Commission's current policy that subfranchisors should provide disclosures about the franchisor, and to the extent applicable, about themselves.[675] Consistent with the UFOC Guidelines, disclosure documents would also have to be written in plain English.[676]

---

[672] 64 Fed. Reg. at 57,315-16. *See also* 16 C.F.R. at §§ 436.1(a) and 436.1(a)(21). The "single document" requirement prevents "piecemeal and confusing disclosures by the franchisor." SBP, 43 Fed. Reg. at 59,682. No comments were submitted in response to this instruction, and we, therefore, recommend that the Commission adopt it in the final revised Rule.

[673] 64 Fed. Reg. at 57,316. *See also* 16 C.F.R. at § 436.1(a)(24). This instruction is intended to "aid the franchisee in using the disclosure document and [is] intended as a remedial measure to prevent franchisors' violations of the rule and the [FTC] Act." SBP, 43 Fed. Reg. at 59,684. No comments were submitted on this proposal, and we recommend that the Commission adopt it in the final revised Rule.

[674] 64 Fed. Reg. at 57,316. *See also* 16 C.F.R. at § 436.1(a)(21). This instruction prevents "the franchisor from 'explaining away' the required disclosures or 'burying' the material information in a mass of less important information." SBP, 43 Fed. Reg. at 59,682.

[675] Final Interpretive Guides, 44 Fed. Reg. at 49,969.

[676] 64 Fed. Reg. at 57,315-16. *See also* UFOC Guidelines, General Instruction 150.

In the second section (NPR section 436.7), the NPR proposed specific instructions pertaining to electronic disclosures.[677] In order to prevent fraud and circumvention of the Rule's pre-sale disclosure requirements, the NPR proposed, among other things, that: (1) prospective franchisees consent to receiving electronic disclosures;[678] and (2) franchisors using electronic media provide prospective franchisees with a paper summary document containing an expanded cover page, table of contents, and acknowledgment of receipt.[679] In addition, all disclosures must be in a form that permits each prospective franchisee to download, print, or otherwise maintain the document for future reference.[680] Multimedia features – such as audio, video, and "pop-up" screens, and external links – would be prohibited in all disclosure documents. In order to facilitate the reading of an electronic disclosure document, however, the NPR proposed

---

[677] 64 Fed. Reg. at 57,316-19. Several commenters urged the Commission to permit franchisors to comply with the Rule electronically. *E.g.,* PMR&W, Comment 4, at 2; McDonalds, Comment 7, at 2; H&H, Comment 9, at 2-3; 7-Eleven, Comment 10, at 2; IFA, Comment 22, at 5-6; Stadfeld, Comment 23, at 4; Frandata, Comment 29, at 1; AFC, Comment 30, at 2. For example, the NFC told us that electronic disclosure will greatly reduce compliance costs, while affording prospective franchisees the opportunity to obtain disclosure documents quickly and to review them "more intelligently" through the use of internal links. NFC, Comment 12, at 14. This will better enable prospective franchisees to comparison shop, improving "the functioning of an already robust marketplace." *Id.* at 15. Frandata estimates that the current cost to print and mail one domestic disclosure document averages about $40. Other administrative expenses (such as those to mail and review application forms, respond to inquiries, and recordkeeping) raise the total cost associated with moving a prospective franchisee through the sales process to nearly $100. Ultimately, electronic disclosure is likely to reduce printing and mailing costs to about $5-10 per document. However, that figure does not include the actual cost to develop, implement, and maintain an electronic disclosure system, which, in Frandata's view, can range from $2,500-$10,000 per year. Nonetheless, Frandata reported that "even with these additional costs, electronic delivery will still dramatically reduce the overall cost of the sales and delivery process." Frandata, Comment 29, at 3-4.

[678] 64 Fed. Reg. at 57,316.

[679] *See id.* at 57,317. The proposed summary disclosure document proposal generated mostly negative comments. PMR&W, for example, opined that the paper summary requirement may be unnecessary in a few years due to advances in confirmation technology. PMR&W, Comment 4, at 4. *But see* Stadfeld, Comment 23, at 15 (supporting summary document proposal). Others believed the summary document proposal is inefficient or burdensome, asserting that franchisors should be able to use electronic means exclusively for Rule compliance. For example, McDonald's urged the Commission to permit "exclusive use of electronic means to communicate all disclosure information." McDonald's, Comment 7, at 2. *See also* 7-Eleven, Comment 10, at 2; GPM Rebuttal, Comment 40, at 8-9.

[680] 64 Fed. Reg. at 57,318.

permitting franchisors to include navigational tools, such as internal links, scroll bars, and search features.[681] Finally, the NPR proposed that franchisors furnishing disclosure document electronically retain a specimen copy of their disclosures for a period of three years.[682]

B. Effect of E-SIGN

On June 30, 2000, Congress enacted The Electronic Signatures in Global and National Commerce Act ("E-SIGN").[683] E-SIGN seeks to eliminate barriers to e-commerce by, among other things, giving legal effect to electronic transactions, including pre-sale disclosure, and permitting electronic signatures. Further, E-SIGN also preserves certain consumer rights. Specifically, it provides that consumers must give their informed consent before engaging in electronic transactions and requires companies to disclose any rights consumers may have to receive paper records and to withdraw previously-given consent to receive electronic records. E-SIGN, however, limits such rights to "consumer" transactions, which it defines as an "individual who obtains, through a transaction, products or services which are used primarily for personal, family, or household purposes."[684] Thus, by its terms, E-SIGN may have rejected restrictions such as those proposed in the NPR for electronic franchise disclosure.

In light of E-SIGN, the staff has reconsidered the NPR proposals. As explained below, we recommend that the Commission eliminate the NPR's proposed electronic disclosure instructions (NPR section 436.7). In lieu of specific electronic disclosure instructions, we recommend that the Commission broaden the proposed revised Rule's general instructions (NPR section 436.6) to cover the furnishing of all disclosure documents, paper and electronic alike. Below we set forth our recommendations for a single, expanded general instructions section, incorporating comments submitted on the original NPR proposals (proposed revised section 436.6).

C. The record and recommendations

1. Proposed section 436.6(a): Form of disclosures

As noted above, the NPR proposed that electronic disclosures "must be capable of being printed, downloaded onto computer disk, or otherwise preserved . . . as one single document."

---

681 *See id.*

682 *Id.* at 57,319.

683 15 U.S.C. § 7001.

684 15 U.S.C. § 7006(1). The narrow definition of "consumer" is not unique. *See* Magnuson-Moss Warranty Act, 15 U.S.C 2301(1) (defining "consumer product" as "tangible personal property . . . which is normally used for personal, family, or household purposes.").

64 Fed. Reg. at 57,345. No significant comments were submitted on this proposal and, therefore, we recommend its adoption in the final revised Rule. However, consistent with E-SIGN, we recommend that the Commission expand the NPR proposal to ensure that all disclosure documents can be stored and preserved, paper and electronic disclosures alike, as follow:

> (a) Disclose the information required in (sections 436.3 - 436.5) clearly, legibly, and concisely in a single document using plain English. The disclosures must be in a form that permits each prospective franchisee to store, download, print, or otherwise maintain the document for future reference.

By instructing that all disclosures must be capable of being stored, downloaded, printed, or otherwise maintained, the revised Rule would ensure that prospective franchisees can retain a copy for future reference, as well as ensure that prospective franchisees can show a copy to their advisors, if they wish to do so.[685] Indeed, inherent in the concept of furnishing disclosures is the prospective franchisee's ability to review the document at will, now and in the future. Thus, for example, a franchisor would fail to furnish disclosures in violation of the revised Rule if it sought to provide disclosures merely by permitting a prospect to glance at a paper copy of its disclosure document, providing a continuous loop video of its disclosure document at a trade show, or transmitting its disclosures via email or the Internet in a format that was incapable of being downloaded or printed.

2. Proposed section 436.6(b): Responses

The NPR's general instructions retained the current Rule provision that franchisors must respond fully to each disclosure Item. If a disclosure item is not applicable, then the franchisor must respond negatively, including a reference to the type of information required to be disclosed by the Item. In addition, each disclosure item must contain the appropriate heading.[686] No commenters raised any concerns about this proposed instruction. Accordingly, we recommend that the Commission retain it in the final revised Rule.

3. Proposed section 436.6(c): Additional materials

In the NPR, the Commission proposed retaining the Commission's current policy prohibiting franchisors from including additional materials in their disclosures, except for information required or permitted by non-preempted state law.[687] This prohibition is necessary to ensure that franchisors do not include information that is non-material, confusing, or distracting

---

[685] *See* Bundy, ANPR, 6Nov97, at 129 (disclosures need to be either downloaded onto disk or provided in paper form).

[686] 64 Fed. Reg. at 57,325. *See also* 16 C.F.R. § 436.1(a)(24).

[687] 64 Fed. Reg. at 57,316. *See also* 16 C.F.R. § 436.1(a)(21).

from the core disclosures. In the proposed electronic disclosure instructions, the Commission also proposed updating the instructions to prohibit the use of new technological developments, such as audio, video, and "pop-up" screens, and external links,[688] which could be used to call attention to favorable portions of a disclosure document or to distract prospective franchisees from damaging disclosures. However, the Commission recognized that navigational features may benefit prospective franchisees by making it easier to read an electronic disclosure document.[689] To that end, the NPR proposed that the Rule specifically permit the use of scroll bars, internal links, and search features.[690]

The NPR's proposed prohibition against adding materials to a disclosure document generated a few comments. As an initial matter, Warren Lewis suggested a minor revision to the proposed exemption for "any materials or information other than that required by this Rule or by State law not preempted by this Rule." He noted that because some of the proposed Rule's disclosures are optional (such as the Item 19 financial performance disclosures), the prohibition on additional information should read "any materials or information other than that required or

---

[688] 64 Fed. Reg. at 57,318. The requirement that a disclosure document be a single document also effectively prohibits franchisors furnishing disclosures via the Internet through a series of linked, but separate, documents. This ensures that an electronic document can be downloaded and printed in its entirety. *See* Bundy, Comment 18, at 13 (suggesting that the Rule should expressly require that all exhibits and attachments must be part of the single disclosure document, and it should prohibit external links). If not, a prospective franchisee downloading or printing an electronic disclosure document may only capture isolated sections of the disclosure document. This would violate the very concept of full disclosure underlying the Rule.

[689] Frandata, for example, observed that internal links will enable a prospective franchisee to shift between the disclosure document and corresponding agreement provisions, "thus affording a franchisee a more intelligent and efficient review of a disclosure document." Frandata, Comment 29, at 4. Indeed, Frandata suggested that the Commission formulate a specific set of cross-links and features in order to ensure that all electronic disclosure documents are uniform. In its view, uniformity would foster comparison shopping among franchise offers. In addition, it would avoid stigmatizing those franchise systems that fail to incorporate features in their electronic disclosure documents. "For example, viewing a document with extensive search features keyed to words in the disclosure document might predispose a prospect to envision that all electronic versions contained such a feature, and would therefore create a negative impression (or customer service issues) for other systems which have not incorporated such a feature, while simultaneously confusing the prospect." *Id.* We would not go so far. Rather than dictate the features that a franchisor should use in preparing disclosure documents, we believe the Rule should allow for maximum flexibility, enabling franchisors to incorporate those features it believes are warranted in light of market forces.

[690] 64 Fed. Reg. at 37,518.

permitted by this Rule . . . ." Lewis, Comment 15, at 19. We agree and recommend that the text of the Rule be modified accordingly.

At the same time, Mr. Lewis maintained that the proposed prohibition "is an unfair trap for franchisors and subfranchisors," asserting:

> [W]e note that a franchisor or subfranchisor sometimes needs to include information in a disclosure document that it believes is material or possibly material (even though the information is not required or permitted under federal or state law) or that it believes will help a prospect to better understand required information or its significance. Providing supplementary or explanatory information of this type should not be a rule violation, unless the information is excessive, misleading, or intentionally diversionary.

Lewis, Comment 15, at 19.[691] In the same vein, H&H noted that the Commission proposed in the NPR that franchisors may have other obligations under Section 5 of the FTC Act to disclose material information beyond that required by the Rule.[692] According to the firm, this leaves the franchise community without clear guidance on what is expected in a disclosure document.

The staff recommends that the Commission continue its long-standing policy of instructing franchisors to include only authorized materials in their basic disclosure document, whether in paper or electronic form. For example, a franchisor would be prohibited from including general advertising, testimonials, or – in the case of electronic media – multimedia tools, in their disclosure documents.[693] On the other hand, the Commission recognized in the NPR the unique features of electronic media, such as scroll bars, internal links, and search features that may aid prospective franchisees in reviewing their disclosures. We continue to agree that such navigational tools serve a useful purpose in an electronic environment and recommend that the Commission specifically authorize the use of such features.[694]

---

[691] *See also* Holmes, Comment 8, at 9; Stadfeld, Comment 23, at 15; BI, Comment 28, at 8.

[692] H&H, Comment 9, at 8.

[693] In response to the same proposal in the NPR, BI told us that the proposed prohibition on the use of multimedia features "appears to be overly broad." BI, Comment 28, at 8. It proposed that the Commission consider that some features may assist a prospective franchisee in reading a disclosure document. BI, however, did not specify which features it had in mind or how those features might assist prospective franchisees.

[694] The proposed revisions, however, make clear that permission to use navigational tools is for the prospective franchisee's benefit. Accordingly, a franchisor's selective use of navigational tools for its own benefit (i.e., to draw the prospect's attention to, or away from, certain disclosure items) would be prohibited.

In reaching this conclusion, we recognize the commenter's concern that it may be desirable to include additional material information in a disclosure document. To that end, we recommend that the Commission clarify in the Compliance Guides that a franchisor can add brief footnotes or other clarifications to ensure that a required disclosure is complete and not misleading. However, we believe it is otherwise inappropriate for a franchisor to add unauthorized information to a disclosure document. This could unnecessarily bulk-up the disclosures, or offer an opportunity to distract attention away from potentially negative disclosures. Finally, we note that the prohibition on adding to a disclosure document is a narrow one. Franchisors are always free to provide prospective franchisees with non-deceptive and non-contradictory information outside of a disclosure document.[695]

So revised, the general "additional material" instruction to the final revised Rule would read:

> (c) Do not include any materials or information other than those required or permitted by this Rule or by state law not preempted by this Rule. For the sole purpose of enhancing the prospective franchisee's ability to maneuver through an electronic version of a 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.

4. Proposed section 436.6(d): Multi-state documents

In the NPR, the Commission proposed permitting franchisors to prepare multi-state documents to include state-specific information either in the text of the disclosure document or in exhibits attached to the disclosure document.[696] In effect, this instruction provides additional guidance on how franchisors may incorporate state-specific information into their disclosures. It also would decrease compliance costs significantly, by enabling franchisors to use one, united disclosure document for both federal and state purposes. No commenters raised any concerns about this proposal. Accordingly, we recommend that the Commission adopt the multi-state instruction in the final revised Rule.

5. Proposed section 436.6(e): Subfranchisor disclosures

The NPR also addressed disclosures by subfranchisors. As proposed in the NPR, "[s]ubfranchisors should disclose the required information about the franchisor, and, to the extent

---

[695] *See* 16 C.F.R. § 436.1(a)(21) ("This does not preclude franchisors . . . from giving other nondeceptive information orally, visually, or in separate literature so long as such information is not contradictory to the information in the disclosure statement.").

[696] 64 Fed. Reg. at 57,316.

applicable, the same information concerning the subfranchisor." 64 Fed. Reg. at 57,316. This language is consistent with current Commission policy.[697]

In response to the NPR, Howard Bundy suggested that the proposed subfranchisor instructions be revised to replace "should disclose" with "shall disclose." Bundy, Comment 18, at 11. He noted that the word "should" implies an advisory only, that is, that a subfranchisor has the discretion to include its own information in the disclosure document. He further recommended that the instructions should use the term "seller" in lieu of "subfranchisor." "Alternatively, the Commission should add a definition of the term 'subfranchisor' and explain what it is limited to in this context." *Id.*

H&H, however, observed that "subfranchising" takes many different forms. For example, a subfranchisor may in fact function as a franchisor by signing a franchise agreement with a subfranchisee, or the franchisor may sign the franchise agreement, but delegate many support functions to the subfranchisor. In the first "example, the proposed [disclosure] requirement may lead to disclosure about the franchisor in a subfranchise offering that is irrelevant and, in some circumstances, could be misleading to prospective franchisees." H&H, Comment 9, at 6.

We agree with Mr. Bundy that the Rule should contain a clear disclosure mandate. Therefore, we recommend that the Commission substitute the word "shall" for "should," as suggested above. At the same time, we recognize H&H's concern. The term "subfranchisor" could be used to describe persons who participate in an array of franchising activities. Indeed, the term is often confused with "brokers" or other franchisor agents. However, as discussed above in connection with the proposed "franchisor" definition, subfranchisors are treated the same as franchisors under the Rule in narrow circumstances only: where the subfranchisor steps into the shoes of the franchisor by both granting franchises, as well as by performing post-sale disclosure obligations.[698]

For the same reason, we are disinclined to recommend that the Commission replace the term "subfranchisor" with "seller" in this context. Such a modification would mean that all

---

[697] Final Interpretive Guides, 44 Fed. Reg. at 49,969. While the Commission has allowed some flexibility in how franchisors and subfranchisors should prepare disclosure documents, it also made clear that both "the franchisor and the sub-franchisor are responsible for each other's compliance with the rule, and are jointly and severally liable for each other's violations." *Id.* The Commission also stated that it expects franchisors and subfranchisors to provide the required background information, litigation, and bankruptcy disclosures of both parties, and that subfranchisors should provide franchisee statistical information in all instances. *Id.*

[698] In our view, a new definition to address subfranchising is unnecessary because the term "franchisor" adequately addresses the issue. We further propose to explain subfranchising more fully in the Compliance Guides, with hypothetical examples.

sellers – including even those franchise brokers who do not perform under the franchise agreement – would be responsible for making their own disclosures, as well as those of the franchisor. That would unnecessarily broaden the Rule's scope. As discussed above in our analysis of Item 2, we have rejected the view that broker information is material and should be included in a franchisor's disclosure document in all instances. Rather, we believe that proposed instruction properly focuses on subfranchisors who sell and perform under the franchise agreement.

6. Proposed section 436.6(f): Disclosure of any prerequisites to receiving or reviewing disclosure documents

We recommend that the Commission adopt a new instruction not previously raised in the NPR. Before a franchisor furnishes a disclosure document, the franchisor would be required to advise prospective franchisees of the formats in which the disclosure document will be made available, any prerequisites for obtaining the disclosure document in a particular format, and any conditions necessary for reviewing the disclosure document in a particular format.[699] This new instruction would ensure that prospective franchisees, prior to disclosure, know whether or not they will receive a disclosure document in a form they can easily use.[700] A franchisor would disclose if it furnishes disclosures, for example, via CD Rom only. In addition, the franchisor must disclose if there are any special conditions to reviewing a disclosure document. For example, the franchisor would disclose whether the prospective franchisee's computer must be capable of reading pdf files or whether any specific applications are necessary to view the disclosures (such as Windows 2000 or DOS, or a particular Internet browser).

---

[699] We further find that this new instruction is a good alternative to a prior consent requirement. Several commenters opposed a prior consent requirement, as proposed in the NPR. *See* NFC, Comment 12, at 15; Frandata, Comment 29, at 5; AFC, Comment 30, at 2. The NFC, for example, feared that an advance consent precondition would stifle new technological advances that would enable franchisors and prospective franchisees to conduct business online "seamlessly," without any additional contacts or discussions. NFC, Comment 12, at 15. *See also* McDonalds, Comment 7, at 2. We agree. Accordingly, we recommend that the Commission permit a wide variety of disclosure formats, provided that the prospective franchisees is made aware of any prerequisites to using them.

[700] This is consistent with our proposal that franchisors be permitted to state in the cover page whether alternative disclosure formats are available and how to obtain one. *See* section VI.A above.

7. Proposed section 436.6(g): Disclosure document recordkeeping

In the NPR, the Commission proposed a recordkeeping requirement for electronic disclosure only.[701] Specifically, franchisors making disclosure electronically would retain, and make available to the Commission upon request, a sample copy of each materially different version of their disclosure documents for a period of three years. In response to the NPR, Howard Bundy urged the Commission to revise the recordkeeping requirement to three years, "or any longer period that the franchisor retains a copy for any purpose." Bundy, Comment 18, at 13. Seth Stadfeld suggested a six-year record retention period, noting that cases involving franchise documents sometimes occur five or even ten years after the initial sale.[702]

As an initial matter, we recommend that the Commission revise the NPR's proposed recordkeeping provision to cover all disclosure documents, regardless of the medium used. This is consistent with E-SIGN, which generally prohibits discriminating between paper and electronic commerce. It is also consistent with standard business practices and state law requirements, and, therefore, should impose only a *de minimis* burden on franchisors. At the same time, a three-year recordkeeping provision will greatly assist the Commission in its law enforcement work, by ensuring the availability of evidence in rule enforcement actions.[703] A longer recordkeeping provision, no doubt, might also assist franchisees who wish to bring common law actions with longer limitations periods. However, we believe such a step is unnecessary in light of the other proposed Rule instructions ensuring that prospective franchisees can retain copies of their disclosures for future reference. In short, it is the responsibility of franchisees to safeguard their disclosure documents post-sale and the Rule instructions, as noted above, accommodate that interest. So revised, the recordingkeeping provision would read:

---

[701] 64 Fed. Reg. at 57,319. The Commission recognized that franchisors might not ordinarily retain old electronic documents. At the same time, any costs associated with the proposed recordkeeping requirement would be substantially outweighed by the vast savings in reduced, or eliminated, printing and distribution costs associated with disseminating paper disclosure documents. *Id.*

[702] Stadfeld, Comment 23, at 5.

[703] Rule enforcement actions brought under Section 19 of the FTC Act have a three-year statute of limitations. 15 U.S.C. § 57b. Reliance on franchisees for copies of disclosure documents in law enforcement work is impracticable. Franchisees may not retain copies or may not have complete copies. Moreover, large franchise systems may use multiple versions of their disclosures over time and in different states. Obtaining all relevant copies from franchisees may be unworkable. Therefore, for law enforcement purposes, it is essential that franchisors retain copies of their disclosures for some length of time, consistent with state practices.

(g) Franchisors shall retain, and make available to the Commission upon request, a sample copy of each materially different version of their disclosure documents for three years after the close of the fiscal year when it was last used.

8. Proposed section 436.6(h): Receipt recordkeeping

In the NPR, the Commission also proposed, in connection with Item 23, that franchisors retain a copy of any receipt involving a completed franchise sale for three years, the statute of limitations for trade regulation rule enforcement actions brought under Section 19 of the FTC Act.[704] There are no comparable provisions in the current Rule. This proposal generated one comment: BI expressed the view that the proposal "provides useful clarification regarding the minimum time period the Commission expects franchisors to maintain such records." BI, Comment 28, at 7-8.

We continue to support a recordkeeping requirement for receipts, but recommend that it be moved from Item 23 to the Rule's instructions section, where it supplements the general disclosure document recordkeeping requirement. Many franchise registration states already require franchisors to maintain complete records involving each franchise sales transaction.[705] Therefore, franchisors routinely ask for and retain some kind of receipt in the ordinary course of business to protect themselves from any future allegations that they sold franchises without disclosure. Thus, a recordkeeping requirement is likely to foster compliance with the Rule's disclosure obligation without imposing significant compliance costs.

VIII. PROPOSED SECTION 436.7: UPDATING REQUIREMENTS.

A. Background

In most respects, the NPR's proposed updating requirements are identical to those set forth in the current Rule. Specifically, the NPR retained the current requirement that franchisors

---

[704] 64 Fed. Reg. at 57,315 and 57,344. Several Commission trade regulation rules also require a three-year recordkeeping requirement. *See, e.g.,* Wool Labeling Rule, 16 C.F.R. at § 300.31(c); Fur Labeling Rule, 16 C.F.R. at § 301.41(b); Textile Labeling Rule, 16 C.F.R. at § 303.39(c); Alternative Fuel Labeling Rule, 16 C.F.R. at § 309.23; R-Value Rule, 16 C.F.R. at § 460.9. *Cf.* Magnuson-Moss Warranty Act Regulations, 16 C.F.R. at § 703.6(f) (4 year recordkeeping provision). *But see* Automotive Fuel Rating Rule, 16 C.F.R. at § 306.7 (one year recordkeeping provision); Telemarketing Sales Rules, 16 C.F.R. at § 310.5(a) (24 month recordkeeping provision); Funeral Rule, 16 C.F.R. at § 453.6 (one year recordkeeping provision).

[705] *E.g.,* Cal. Corp. Code at § 31150; Haw. Rev. Stat. at § 482E-5; 815 Ill. Comp. Stat. at § 705/36; Md. Code Ann, Bus. Reg. at § 14-224; Minn. Stat. at § 80C.10; N.D. Cent. Code at § 51-19-16; Or. Rev. Stat. at § 650.010; R.I. Gen. Laws at § 19-28.1-13; Wash. Rev. Code at § 19.100.150.

prepare annual updates within 90 days of the close of their fiscal year and quarterly updates, if applicable, thereafter.[706] The proposed updating requirements would also retain 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.[707]

The updating requirements of the NPR differ from those of the current Rule, however, in one important respect. As proposed in the NPR, franchisors would have a continuing update requirement. Specifically, when furnishing disclosures, franchisors would be required to notify a prospective franchisee of any additional material changes that occurred since the last quarterly update. Similarly, when delivering the franchisee agreement, the franchisor would be required to notify the prospective franchisee of any other known material changes "in the franchisor, the franchise business, or franchise agreement." 64 Fed. Reg. at 57,345.

B. The Record and Recommendations

1. Proposed section 436.7(a): Annual updates

As noted above, the NPR proposed retaining the current 90-day annual update requirement.[708] In response, several commenters urged the Commission to adopt a 120-day requirement. For example, PMR&W told us that many franchisors have difficultly obtaining annual audited financial statements from their auditors within the current 90-day period. Because most franchisors use the calendar fiscal year, company auditors are usually overwhelmed at the beginning of the fiscal year, given the busy tax season. Recognizing this problem, many state franchise regulators allow franchisors 120 days to prepare updated disclosures.[709] For these reasons, the staff recommends that the Commission revise the Rule to extend the annual updating period to 120 days. This revision has the potential of reducing franchisors' compliance burdens, while potentially reducing inconsistencies with state updating provisions.

2. Proposed sections 436.7(b)-(c): Quarterly updates

In the NPR, the Commission proposed retaining the quarterly update requirement. The proposed basic quarterly update requirement generated no significant comment. PMR&W, for

---

[706] 64 Fed. Reg. at 57,319. *See also*16 C.F.R. § 436.1(a)(22).

[707] 64 Fed. Reg. at 57,319. No comments were submitted on this issue and we therefore recommend that the Commission retain it in the final revised Rule.

[708] 64 Fed. Reg. at 57,319.

[709] PMR&W, Comment 4, at 5. *See also* Baer, Comment 11, at 4; Lewis, Comment 15, at 19-20; IFA, Comment 22, at 11; J&G, Comment 32, Attachment, at 3.

example, noted that the current quarterly update requirement is a bright-line rule that "is clear and intelligible to franchisors and their counsel." PMR&W, Comment 4, at 6. Similarly, the NFC states that it is "in accord with the Commission's post-quarterly update 'material change' disclosure requirement." NFC, Comment 12, at 16.

We agree. The quarterly update requirement strikes the right balance between ensuring the timeliness of disclosures and reducing compliance burdens. Franchisors need to prepare quarterly updates only if there is a material change, and they may include the quarterly update in an addendum. In short, franchisors need not prepare new disclosure documents each quarter as a matter of course. We believe the current quarterly update requirement establishes a clear, bright line tied to each franchisor's fiscal year. It has worked well and has generated few, if any, complaints during the 20 years that the Rule has been in existence. Accordingly, we recommend that the Commission retain the quarterly update requirement.

Nonetheless, the staff recommends that the Commission modify the quarterly update provision if the Commission ultimately adopts the proposed 120-day annual update period. A 120-day period would overlap a quarterly (typically 90 days) update period: indeed, the obligation to update disclosures quarterly would precede the conclusion of the 120 days. Accordingly, additional clarification of the interrelationship between the annual and quarterly update requirements is warranted.

We recommend that a franchisor's annual update (120 days after the close of the fiscal year) also include any first quarterly update information (90 days), either by integrating the quarterly updated information into the body of the disclosure document or by attaching an addendum. The following tables will illustrate the point, by comparing procedures under the current Rule with those under the staff's recommended revision.

Hypothetical Using Procedures Under the Current Rule

December 31, 2002	Fiscal year ends
January-March, 2003	First quarter of new fiscal year
April, 1, 2003	Franchisor must use annual updated disclosure document
Reasonable time after April 1, 2003	Franchisor amends annual update with a quarterly update, if warranted.
Reasonable time after July 1, 2003	Franchisor amends annual (and any previous quarterly update) with a quarterly update, if warranted.
Reasonable time after October, 1, 2003	Franchisor amends annual update (and any previous quarterly update(s)) with a quarterly update, if warranted.
Reasonable time after January 1, 2004	Franchisor amends 2003 annual update (and any previous quarterly updates(s)) with a quarterly update, if warranted.

Hypothetical Using Proposed Revised Procedures

December 31, 2002	Fiscal year ends
January-March, 2003	First quarter of new fiscal year
May, 1, 2003	Franchisor must use annual updated disclosure document containing any first quarter update either integrated in the body of the disclosure document itself or in an addendum
Reasonable time after July 1, 2003	Franchisor amends annual update with a quarterly update, if warranted.
Reasonable time after October 1, 2003	Franchisor amends annual update (and any previous quarterly update(s)), with a quarterly update, if warranted.
Reasonable time after January 1, 2004	Franchisor amends annual update (and any previous quarterly updates(s)), with a quarterly update, if warranted.

3. Proposed section 436.7(d): Material change disclosures

As discussed above, the NPR proposed a limited continuing disclosure obligation. Specifically, franchise sellers would notify prospective franchisees of any material changes when furnishing disclosures and when presenting the completed franchise agreement.[710] This proposal

[710] 64 Fed. Reg. at 57,319.

would not require franchisors to amend their disclosure document, which might impose unwarranted costs. Rather, the franchisor would simply notify the prospective franchisee of the material change. An oral statement or a faxed letter, for example, would suffice.

In the NPR, the Commission explained the purpose of the proposed expanded updating requirement as follows. A franchise system may change considerably after a prospective franchisee receives his or her disclosure document. For example, the franchisor may file for bankruptcy or lose a class action suit that affects its ability to continue in business. Yet, a prospective franchisee who receives disclosures in the quarter in which such an event occurs might not learn of those material changes. Under the circumstances, it could be an omission of material information in violation of Section 5 for a franchisor to fail to alert prospective franchisees about recent material changes when it knows that prospects are relying on incomplete or inaccurate information contained in the previously issued disclosure document.[711]

The NPR generated several comments, both supporting and opposing the expanding updating proposal. The IL AG and Howard Bundy favored the continuing update requirement, but they would require all such updates to be in writing. The IL AG, for example, stated that "[o]ral notification is the ammunition for rescission litigation." IL AG, Comment 3, at 4.[712] On the other hand, several franchisors opposed the updating requirement for various reasons. Marriott, for example, asserted the proposal is extremely burdensome, imposing "an impossible burden on large franchisors, especially if they actually operate the business that they franchise because of the uncertainty of what constitutes 'any material change' and the requirement of 'real

---

[711] *Id.*

[712] *See also* Bundy, Comment 18, at 13; BI, Comment 28, at 8-9. On the other hand, the NFC praised the Commission's flexibility in permitting notification by any means:

> The Commission's proposed paradigm enabling franchisors to communicate such post-quarterly update "material changes" to prospective franchisees without the need to amend their disclosure document will respond to the needs of the marketplace without reducing the quantum of pre-sale disclosure furnished to franchisees. The Commission is to be commended for taking this enlightened approach.

NFC, Comment 12, at 16.

time' ongoing disclosure." Marriott, Comment 35, at 3-4.[713] Marriott would eliminate the proposed expanded updated provision in its entirety.[714]

PMR&W and the NFC advised that the proposal is confusing. In particular, PMR&W found the relationship between the basic quarterly update provision and the proposed continuing update provision less than clear:

> It is unclear whether these "material changes" must be more "material" than any changes disclosable in the quarterly updates. Depending on the answer to this question, is there any need to require quarterly updates when immediate updates are mandated; i.e., does the immediate update rule preclude the need for the quarterly update?

PMR&W, Comment 4, at 6.

In a similar vein, the NFC questioned whether a franchisor must provide a prospective franchisee with each and every quarterly update, as long as the prospect is in the sales cycle. If so, it asked how franchisors should determine whether prospects are no longer in the sales cycle. "It is unclear whether franchisors must notify such 'deleted prospects' in order to avoid non-compliance." NFC, Comment 12, at 16.

Based upon the comments, it is clear that there are two competing concerns that defy easy resolution. On the one hand, prospective franchisees should have all material information they need to make an informed purchase decision, regardless of when they entered the sales process.

---

[713] Marriott noted that it, and other large corporations, may have several thousand employees in different departments. Each department (e.g., training, legal, advertising, marketing) may have a different person responsible for a portion of the information that is in a disclosure document for each different brand offered. A continuous updating requirement:

> would place an unfair burden on franchisors like Marriott. For example, it will be virtually impossible for the Training Department (every time they change a subject or the hours allotted to a particular subject in the training program) . . . to contact Legal and for Legal to determine if the change is material and to then contact development to make sure before the closing of every franchise deal that there is not a particular piece of information that must be notified to a franchisee. This requirement will cause complete havoc on the franchise sales process. Franchisors will not be able to close sales without notifying every department out of fear that some minute change in fact may later be deemed to be material.

Marriott, Comment 35, at 4.

[714] *Id. See also* PMR&W, Comment 4, at 6.

On the other hand, there are practical considerations, including the costs and burdens on franchisors to update each franchisee on a continuing basis, as Marriott observed. Indeed, at some point, the burden and cost to franchisors (which inevitably will be passed along to prospective franchisees or other consumers), outweighs the potential benefit of more frequent updating.

After reviewing the comments and considering the competing concerns, the staff concludes that, on balance, the NPR's proposed continuing update requirement is largely unwarranted, with the exception of financial performance representations. We are convinced that franchisors should have a bright-line directive when they can be assured that they have complied with the Rule's disclosure requirements. We believe that the traditional quarterly update requirement is sufficient to ensure timely disclosures,[715] while minimizing compliance costs. At the same time, we note that a general continuing update requirement may be unwarranted in light of Section 5 of the FTC Act. As explained in section V above, a franchise seller's compliance with the Franchise Rule does not alone shield the seller from Section 5's prohibition against deceptive conduct, such as misrepresenting its offering or omitting material information to prospective franchisees. Accordingly, franchise sellers may have an obligation to alert prospective franchisees about recent changes not reflected in their quarterly updates.[716]

Further, any prospective franchisee who has been in the sales cycle can always request a copy of the franchisor's most recent disclosure document before he or she agrees to execute the franchise agreement. To that end, we further recommend that the Commission adopt a new prohibition that would bar franchisors from failing to honor a prospective franchisee's reasonable request for a copy of the franchisor's most recent disclosure document and/or quarterly update before he or she signs a franchise agreement.[717] We believe this proposed new prohibition is unlikely to increase franchisor's compliance costs and burdens. Franchisors most likely will

---

[715] We recognize that the proposed quarterly update requirement may be misinterpreted as implying that franchisors must provide each prospective franchisees with each quarterly update that is generated throughout the sales cycle. We do not believe that was the Commission's intention. Rather, the Commission intended that prospective franchisees should receive the basic disclosure document and any quarterly updates that exist at the time the prospect is to receive disclosures. There is no continuing obligation on the franchisor's part to provide quarterly updates to a prospective franchisee throughout the sales cycle. The staff recommends that the Commission make this point clear in the Compliance Guides.

[716] Franchisors also have similar obligations to disclose under common law fraud and misrepresentation principles.

[717] This proposal would also address the commenters' concerns about permitting franchisors to furnish updates orally.

have updated disclosures documents prepared in the ordinary course of their business.[718] With the advent of electronic communications, emailing a copy of the updated disclosure document to a prospective franchisee, or otherwise permitting a prospective franchisee to see a copy of the updated disclosure document on the franchisor's website, would impose only a small cost.

Nonetheless, we recommend that the Commission retain the continuing update requirement for financial performance information. Currently, the Rule requires franchisors to notify prospective franchisees of any changes in financial performance representation before the prospective franchisee pays a fee or signs the franchisee agreement.[719] We believe this provision is sound, recognizing the particular materiality of financial data to prospective franchisees. Any false impression created by stale data at the time of sale is likely to cause significant injury to prospective franchisees who rely on them in making their investment decision.[720]

IX. PROPOSED SECTION 436.8: EXEMPTIONS

A. Background

We now turn to the next section of the proposed final revised Rule – exemptions. Currently, the exemptions are set out in the middle of the Rule's definitions, where they modify the term "franchise."[721] To make the exemptions easier to find, the Commission proposed creating a distinct exemptions section in the NPR.[722] The NPR proposed retaining the current

---

[718] This revised proposal would require franchisors to do nothing more than furnish updated copies of its disclosures documents to prospective franchisees, upon request before the signing of the franchise agreement. Therefore, the proposal also renders moot commenters' concerns about inconsistencies in the scope of the information that franchisors would need to update.

[719] 16 C.F.R. §§ 436.1(d)(2) and 436.1(e)(6).

[720] No commenters raised any concerns about the obligation to update information pertaining to financial performance. Accordingly, we propose that the Commission retain this provision in the final revised Rule.

[721] *See* 16 C.F.R. § 436.2(a)(3). The UFOC Guidelines do not contain any exemptions. Rather, at most, some of the 15 franchise disclosure states may exempt franchisors from registration requirements, as a matter of statute or regulation. *See generally,* Duvall & Mandel, ANPR 114. Thus, franchisors exempted from disclosure under the revised Rule would nonetheless have to prepare and disseminate UFOCs in the 15 franchise registration states.

[722] 64 Fed. Reg. at 57,319-22. This approach is consistent with other Commission rulemakings, including the Telemarketing Sales Rule, 16 C.F.R. § 310.6; the Care Labeling Rule, 16 C.F.R. § 423.8, and the Cooling-Off Period Rule, 16 C.F.R. § 429.3.

Rule exemptions for: (1) fractional franchises;[723] (2) leased departments;[724] (4) oral contracts;[725] and (5) franchise sales under $500.[726] At the same time, the NPR proposed adding several new exemptions.[727] Specifically, the NPR would exempt franchise sales involving petroleum marketers and sophisticated investors.[728] Finally, the NPR proposed eliminating the four exclusions current found at 16 C.F.R. § 436.2(a)(4)(i)-(iv) for relationships involving: (1) employer-employees and general partnerships; (2) cooperative organizations; (3) testing or certification services; and (4) "single" licenses.[729]

B. The Record and Recommendations

Except as already discussed in the definitions sections below, no commenters raised any additional concerns about exemptions for fractional franchises, leased departments, or oral contracts. We recommend, therefore, that the Commission retain them in the final revised Rule. A few commenters, however, raised concerns about the current Rule's $500 required minimum payment exemption found at 16 C.F.R. § 436.2(a)(3)(iii).

---

[723] 64 Fed. Reg. at 57,320. *See also* 16 C.F.R. § 436.2(a)(3)(i).

[724] 64 Fed. Reg. at 57,320. *See also* 16 C.F.R. at § 436.2(a)(3)(ii).

[725] 64 Fed. Reg. at 57,322. *See also* 16 C.F.R. at § 436.2(a)(3)(iv).

[726] 64 Fed. Reg. at 57,320. *See also* 16 C.F.R. at § 436.2(a)(3)(iii).

[727] The NPR also implied that the exemptions apply only to the Rule's pre-sale disclosure obligations. 64 Fed. Reg. at 57,345. If so, franchisors exempt from the Rule's disclosure requirements nonetheless would be covered by the Rule's prohibitions. *See* Baer, Comment 11, at 15; Gurnick, Comment 21A, at 7-8. We do believe such an approach is unsound. Many of the Rule's prohibitions are tied directly to franchisors' disclosure obligations, such as the prohibition on making contradictory statements. It would be inconsistent to exempt a franchisor from disclosure while prohibiting the same franchisor from making statements contrary to its disclosures. Similarly, it would be inconsistent to exempt a franchisor from financial performance disclosures while prohibiting the franchisor from making financial performance disclosures without an Item 19. To avoid such inconsistencies, we propose that the Rule make clear that the exemptions apply to Rule sections. Of course, franchisors nonetheless may still be held liable under Section 5 for false and deceptive statements and omissions.

[728] 64 Fed. Reg. at 57,320-22.

[729] *Id.* at 57,319.

1. Proposed section 436.8(a)(1): Minimum payment exemption

a. Background

In the NPR, the Commission proposed retaining the current Rule's $500 required minimum payment exemption found at 16 C.F.R. § 436.2(a)(3)(iii).[730] This exemption ensures that the Rule "focus[es] 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." SBP, 43 Fed. Reg. at 59,704. At the same time, the Commission asked whether the current $500 threshold would continue to serve a useful purpose if the Commission were to create a separate business opportunity rule. It also asked what threshold is appropriate to ensure that the Rule continues to cover transactions involving a "personally significant monetary investment?" 64 Fed. Reg. at 57,331.

b. The record and recommendations

In response to the NPR, several commenters urged the Commission to raise the $500 minimum threshold, while one favored retaining the current $500 threshold. None recommended eliminating or reducing the threshold. Specifically, H&H urged the Commission to raise the threshold to $1,000[731] in order to recognize the fact that costs in general have increased substantially since the Rule was initially promulgated. The firm also suggested that the threshold be increased "perhaps every 4 years to reflect a reasonable rate of inflation." H&H, Comment 9, at 4.

John Baer suggested that the level be set at $2,500, with an inflation adjuster. In the alternative, he suggested that the threshold should be set at "1% of the amount of average retail sales achieved by outlets using the franchise system in the United States in the most recent year for which data is available." Baer, Comment 11, at 15-16. Mr. Baer asserted that if "a system has average retail sales of $1 million, $10,000 is not a number which should trigger concerns. There is no need for the Commission to regulate *de minimis* investments with this type of burdensome and costly disclosure obligation." *Id.* J&G recommended increasing the threshold to $5,000.[732]

In contrast, the IL AG urged the Commission to retain the $500 threshold in order to protect small investors:

---

[730] 64 Fed. Reg. at 57,320.

[731] *See also* Gurnick, Comment 21A, at 8; GPM Rebuttal, Comment 40, at 9 (at least $1,000).

[732] J&G, Comment 32, at 14.

> The best solution is to leave this almost universal element of the franchise definition as is. The reality is that a $500 up-front investment, is only the tip of the iceberg in virtually every franchise system. Royalties, equipment purchases, leases, inventory, and myriad other payments and contractual obligations put most franchisees at great financial risk while having little or no direct experience to make life-changing decisions. To exempt franchisees that do not have an initial fee, or ones that have what appears to be a modest fee of $1,000 or $2,500, would put too many "small" investors at risk.

IL AG Rebuttal, Comment 38, at 2.

In a similar vein, Howard Bundy urged the Commission to modify the minimum payment exemption to provide that the $500 threshold includes "both amounts the franchisee actually pays, but also any amounts that the franchisee, during the first six months, agrees to pay in the future – either by contract or by practical necessity." Bundy, Comment 18, at 14.

For the following reasons, the staff recommends that the Commission retain the current minimum payment exemption. We begin our analysis by noting that there is no question that the Commission included a threshold dollar amount in the original Rule to exclude small investments, where the financial risk does not warrant the expense and burden of preparing a disclosure document. This is particularly true with low-end business opportunities, which, even today, may cost under $500. However, with the separation of business opportunities from the Franchise Rule, a strong argument can be made that *any* investment in a franchise, as a practical matter, will be a significant investment risk, suggesting that the exemption may no longer serve a useful purpose.

In order to gain a handle on the cost of purchasing a franchise, the staff examined over 1,000 franchise profiles listed in Bond's Franchise Guide (13th ed. 2001).[733] Except for 41 systems, all of the franchise systems responding to Bond's survey reported initial franchise fees of $5,000 or more (approximately 96% of reporting systems). Indeed, only 22 systems reported an initial fee was "not applicable," or charged an initial franchisee fee of $1,000 or less.[734] Under the circumstances, even a $5,000 threshold would not reduce significantly the number of franchisors that must comply with the Rule's disclosure obligations.

---

[733] Bond's keeps files on 2,500 American and Canadian franchise systems. Of these, Bond's surveyed 2294 systems that it identified as current and active. Detailed profiles of the 1050 systems responding to the survey appear in Bond's 2001 edition.

[734] We note that Bond's does not report "required payments," but initial franchisees fees and total investments. Therefore, it is likely that at least some franchise systems charging a minimum fee or even no initial fee (14 systems) actually collect other required payments (e.g., royalties, equipment), making the overall financial risk in purchasing a franchise significant.

Under the circumstances, a plausible argument could be made for eliminating the threshold altogether. However, we would not go that far. We believe that the minimum payment exemption continues to serve a very narrow, but important, purpose: to further distinguish between franchises and business opportunities. While we believe the proposed definition of "franchise" set out in this Staff Report is sufficient to distinguish between franchise and business opportunity arrangements in most instances, we recognize that the distinction between a franchise and business opportunity may not be apparent in all scenarios. To the extent that a low-end business opportunity might come close to satisfying the elements of a franchise, the $500 threshold would help to make it clear that such opportunities are exempt from the Franchise Rule.

At the same time, we agree with Mr. Bundy that the $500 minimum payment exemption should reference payments by contract or by practical necessity. However, the $500 minimum payment exemption already references the term "required payment," which in turn is defined to include both payments by contract and by practical necessity.[735] Accordingly, no further revision is necessary. In addition, we would stop short of adopting Mr. Bundy's suggestion that the required payments include amounts "the franchisee . . . during the first six months, agrees to pay in the future." While we believe the exact amount of required payments need not be fixed at the time of the franchise sale – such as future royalties – purely speculative post-sale commitments to make payments are too uncertain to trigger a franchisor's pre-sale disclosure obligation.[736]

2. Proposed section 436.8(a)(4): Petroleum marketers and resellers exemption

As noted above, the NPR[737] proposed adding a new exemption for petroleum marketers and resellers covered by the Petroleum Marketing Practices Act ("PMPA").[738] In 1980, the Commission granted a petition for an exemption from the Rule filed by several oil companies

---

[735] *See* section IV.O. below.

[736] This issue has been discussed at length in several staff advisory opinions. *See* Advisory 99-1 (Mar. 30, 1999), Bus. Franchise Guide (CCH) ¶ 6498 at 9710 (distinguishing between speculative obligations to make a payment and obligations to make a payment of an uncertain amount); Advisory 97-9 (Dec. 18, 1997), Bus. Franchise Guide (CCH) ¶ 6489 at 9694 (speculative future payments not included in determining applicability of exemption); Advisory 98-5 (June 24, 1998), Bus. Franchise Guide (CCH) ¶ 6494 at 9707 (Rule does not require amount to be fixed at time of sale); Advisory 93-12 (Jan. 28, 1994), Bus. Franchise Guide (CCH) ¶ 6465 at 9635-6 (setting forth criteria for analyzing future payments).

[737] 64 Fed. Reg. at 57,320.

[738] 15 U.S.C. § 2801.

and oil jobbers, pursuant to Section 18(g) of the FTC Act.[739] Specifically, the Commission stated that the Rule "shall not apply to the advertising, sale or other promotion of a [petroleum] 'franchise,' as the term 'franchise' is defined by the [PMPA]." 45 Fed. Reg. at 51,766.[740]

As explained in the NPR, since 1980, the Commission has received only isolated complaints regarding abuses in the relationship between petroleum company franchisors and their franchisees, and we have no reason to believe that a pattern of abuse is likely to develop in the near future. Moreover, in granting the petition, the Commission committed itself to handling any abuses in this field through an industry-specific rulemaking.[741] For these reasons, the NPR proposed that the Commission incorporate its 1980 policy exemption into the Rule as an express Rule exemption.[742]

In response, only one commenter voiced any concerns. J&G maintained that the proposal leaves unanswered whether disclosure is warranted when other businesses – such as convenience stores, fast food, and ice cream shops – operate in these exempt gasoline franchise establishments.[743] While we recommend that the Commission adopt the proposed petroleum marketers exemption as set forth in the NPR, we reject the suggestion that non-petroleum

---

[739] 45 Fed. Reg. 51,765 (Aug. 5, 1980).

[740] In considering the petition, the Commission noted that the most frequently cited complaint 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 those complaints, requiring, among other things, pre-sale disclosure of franchisees' termination and renewal rights. In light of that legislation, the Commission concluded that the Franchise Rule was largely duplicative of the PMPA and related federal regulations. In reaching its conclusion, the Commission nonetheless recognized that circumstances may change in the industry that 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.

[741] *Id.*

[742] 64 Fed. Reg. at 57,320.

[743] J&G, Comment 32, Attachment at 6.

businesses should be included in the exemption. The Commission's policy exemption for petroleum franchises was based on the finding that any problems in that specific industry were addressed by the PMPA. The PMPA has not been revised to extend to non-petroleum businesses, nor are we aware of any other applicable legislation. Indeed, in the absence of any additional information in the record, it would appear that an individual who operates a gasoline station is just as much in need of pre-sale disclosure for the purchase of a non-related franchise, such as an ice cream store, as any other member of the public. We believe the fractional franchise exemption, coupled with the sophisticated investor exemptions discussed below, are the appropriate vehicles for limiting the Rule's scope in this arena.

3. Proposed sections 436.8(a)(5) Sophisticated investor exemptions

a. Background

In the NPR, the Commission proposed adopting three new exemptions, which collectively can be referred to as the "sophisticated investor" exemptions: (1) the large investment exemption; (2) the large corporate-franchisee exemption; and (3) the officer and owner exemption.[744] Below, we first analyze the record on the proposal to create sophisticated investor exemptions, and then we turn to the merits of each of the three specific exemption proposals noted above.

b. The record and recommendations

During the ANPR and NPR proceedings franchisors supported sophisticated investor exemptions,[745] while franchisees and their advocates opposed them, or expressed reservations.[746] In support, franchisors raised essentially two points: (1) the Rule's disclosure requirements are unnecessary when it comes to sophisticated investors; and (2) the Rule's procedures make it difficult for sophisticated investors to conduct business. On the first point, commenters noted that franchising today often involves heavily-negotiated, multi-million dollar deals between

---

[744] 64 Fed. Reg. at 57,320-22.

[745] *See, e.g.,* PMR&W, Comment 4, at 2; 7-Eleven, Comment 10, at 2; NFC, Comment 12, at 17; IFA, Comment 22, at 7; AFC, Comment 30, at 2-3; Marriott, Comment 35, at 6; GPM Rebuttal, Comment 40, at 9-10; Tifford, ANPR 78, at 2-3; Duvall & Mandel, ANPR 114, at 2-3; Cendant, ANPR 140, at 2; Kaufmann, ANPR, 18Sept97 Tr, at 190; Wieczorek, *id.* at 192; Forseth, *id.* at 194-95. .

[746] *See, e.g.,* Bundy, Comment 18, at 14; Stadfeld, Comment 23, at 7-8; Karp, Comment 24, at 6-8. *But see* Caruso, ANPR 118 ("[F]ranchisees in the larger successful systems are themselves fairly sophisticated and in less need of protection by the FTC or any other government agency.").

franchisors and highly sophisticated individuals and corporate franchisees who are represented by counsel. In the course of such deals, franchisees often demand and receive information from the franchisor that equals or exceeds the disclosures required by the Rule. These commenters asserted that these are not the kinds of franchise sales that the Commission originally intended to cover.[747]

For example, the NFC observed that the face of franchising has changed over the last decade, rendering a Rule of broad applicability unwarranted:

> While franchising's roots may be traced to the grant to an individual franchise to one entrepreneur (or a small group of entrepreneurs) possessing no prior knowledge of or experience in the subject industry . . . it is nevertheless the case that over the past decade many of America's oldest and largest franchisors do not follow that paradigm. Instead, they find it far more efficient and profitable for all concerned to largely restrict the grant of United States franchises to: (i) sophisticated corporations with the resources and background necessary to optimally operate subject franchisees, and (ii) existing franchisees whose experience, profitably and mastery of the franchisor's system strongly suggest future success.

NFC, Comment 12, at 17.

On the second point, some commenters asserted that the Rule's mandatory waiting requirements to review disclosure documents and contracts impose unnecessary costs on sophisticated franchisees 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.[748] One commenter observed that while franchisors can file individual petitions for exemptions to the Rule under Section18(g) of the FTC Act, the process is costly and the delay involved often renders this approach an unviable option.[749]

---

[747] *E.g.,* NFC, Comment 12, at 17; Marriott, Comment 35, at 6. GPM observed that the Rule's purpose was to level the playing field between the franchisor and franchisee. "Where the playing field is already level . . . no such need [for disclosure] exists." GPM Rebuttal, Comment 40, at 9-10.

[748] *See* Kaufmann, ANPR, 18Sept97 Tr, at 165; Wieczorek, *id.* at 187-88; Tifford, *id.* at 194.

[749] Duvall & Mandel, ANPR 114, at 16. Section 18(g) of the FTC Act provide a mechanism for parties to petition for relief from Commission trade regulation rules where potential abuse is unlikely. Section 18(g) exemptions petitions are placed on the public record for comment. The entire process of reviewing and granting such a petition may take over one year.

Several commenters urged the Commission to go further and create additional sophisticated investor exemptions. For example, McDonald's believed that sophisticated investors should include "individuals who own two or more franchises or multiple outlets under one franchise." McDonald's, Comment 7, at 2. In its view, such individual's actual experience may serve as the basis for their decision to enter into additional franchise agreements or open additional outlets. Similarly, the NFC proposed that existing franchisees who have operated units for at least two years should be exempt. It noted that several states have such exemptions from registration, including, for example, California (an additional franchise offer) and New York (franchisee already operating a franchise for 18 months).[750]

Support for creating sophisticated investor exemptions, however, was not unanimous. Several franchisee representatives feared that while prospective franchisees may appear to be sophisticated because of their net worth or general prior business experience, they actually may have limited knowledge of the risks inherent in operating the specific franchise being offered. In short, these commenters advised the Commission to protect the wealthy, but inexperienced.[751]

After considering the comments, the staff recommends that the Commission adopt the NPR's proposed sophisticated investor exemptions, albeit with some modifications. We are convinced that the Rule's costs and burdens are unwarranted in situations where the potential for abuse is unlikely. This view finds support in Section 18(g) of the FTC Act. We believe Rule exemptions for sophisticated investors are entirely consistent with this statutory scheme. The Section 18(g) process, however, may be an ineffective means of providing such relief as a practical matter in the franchise context. The lengthy petition process may impose significant costs on franchisors and, perhaps more important, the petition review process often diverts scarce Commission resources away from traditional law enforcement. On balance, we believe that sufficiently limited sophisticated investor exemptions offer the potential for reducing franchisors' regulatory burdens and preserving Commission resources without sacrificing protections for the average investors the Franchise Rule was originally promulgated to protect.

In reaching our conclusion, we have considered, but rejected, expanding the NPR's proposed exemptions to include sales both to existing franchisees who renew or extend their contract or to existing franchisees who purchase additional outlets.[752] We believe these

---

[750] NFC, Comment 12, at 18-19. *See also* BI, Comment 28, at 4 (FTC should exempt individuals with 5 years of experience in the industry).

[751] *See* Zarco & Pardo, ANPR 134, at 4-5; Kezios, ANPR, 6Nov97 Tr, at 47-48; Bundy, *id.*, at 48-49; Stadfeld, Comment 23, at 8; Karp, Comment 24, at 6-8; NFA, Comment 27, at 3.

[752] *E.g.*, Tifford, ANPR 78, at 2; Duvall & Mandel, ANPR 114, at 21-22. Mr. Tifford also suggested that the Commission adopt additional exemptions recognized under state law, including exemptions for franchise sales to financial institutions and sales by fiduciaries or court officials. Tifford, ANPR 78, at 2-3. After considering this issue, we conclude that additional

suggested exemptions are unwarranted. It is already Commission policy that franchisors need not make disclosures to existing franchisees who renew or extend their franchise agreements, unless there has been a material change in the terms and conditions of the proposed franchise agreement.[753] While an argument could be raised that renewing franchisees already are familiar with the franchise system, that argument is undercut by the repeated submission of franchisee comments voicing concerns about renewal terms and conditions.[754] It is clear from the record that renewal terms can differ considerably from the franchisee's original contract and could create a business environment significantly different from the one in which the renewing franchisee has conducted business. On balance, we find that the benefit of disclosure to renewing franchisees under materially different terms outweighs the potential costs.

For similar reasons, we see little benefit in adopting a broad exemption for additional franchise sales to existing franchisees. A franchisee's experience within a franchise system alone is an insufficient basis to avoid pre-sale disclosure. In our experience, many franchise owners are not necessarily sophisticated about their franchisor, or are too busy operating their individual outlets to pay attention to developments within their franchise system. Some franchisees also report that franchisors encourage poorly-performing franchisees to open additional units in order to become successful, asserting that economies of scale will reduce overall costs and promote growth.[755] These are among the very consumers the Rule should protect – vulnerable small franchise owners. In those instances where a franchise-owner is truly sophisticated and is purchasing multiple units, the proposed large investment exemption described below should provide sufficient relief from Rule coverage.

---

exemptions are unwarranted. First, financial institutions will probably qualify for the large corporation exemption detailed below. Second, the definition of "franchise seller" includes the franchisor and those in a business relationship with the franchisor (e.g., brokers and agents). By implication, it excludes judicial officers, such as a receiver.

[753] Final Interpretive Guides, 44 Fed. Reg. at 49,969.

[754] *E.g.,* Bores, ANPR 9, at 1; Paquet, ANPR 18, at 1; Bell, ANPR 30, at 1; Rachide, ANPR 32, at 1; Chabot, ANPR 37, at 1; Rich, ANPR 65, at 1; Orzano, ANPR 73, at 1; Zarco & Pardo, ANPR 134, at 4; AFA, Comment 14, at 5; Bundy, Comment 18, at 9; Morrill, Comment 31, at 2.

[755] For example, Baskin Robbins franchisees submitted several comments stating that their franchisor often requires them to open additional units and, if they choose not to expand, they may face the loss of their existing units. *E.g.,* Keating, ANPR 146 at 1-2.

c. Proposed section 436.8(a)(5)(i): Large investment exemption

In the NPR, the Commission proposed exempting franchise sales where the investment totals at least $1.5 million.[756] As noted in the NPR, very few consumers are likely to have $1.5 million available to invest in a franchise, and the few who do are likely to be experienced business persons.[757] Moreover, the proposed large investment exemption has additional safeguards beyond the $1.5 million threshold to ensure that the exemption covers only the truly sophisticated. 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 requires a $1.5 million investment will have to turn to bankers or other sources of financing. Lenders are likely to ensure that the investor has conducted a due diligence investigation of the offering before approving any loan.[758] 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 would reduce the probability that the franchisor will misrepresent the cost of the franchise to qualify for the exemption, as well as provide a paper trail in the event an enforcement action becomes necessary.[759]

The comments submitted in response to the proposed large investment exemption were predictably split between franchisor and franchisee interests. In general, franchisors enthusiastically welcomed the proposed exemption. Marriott, for example, stated that not only are sophisticated franchisees able to protect their own interest, but the self-interest of others involved in the project, such as bankers, are sufficient to protect those interests as well.[760] Franchisees, on the other hand, were less enthusiastic about the proposed exemption, either opposing it or offering suggestions to limit it on two grounds: (1) wealth alone does not equate

---

[756] 64 Fed. Reg. at 57,320-21. No state has a similar exemption. However, two states provide some form of exemption for transactions involving large initial investments. Illinois permits a franchisor to apply for an exemption from both registration and disclosure where the investment for a single franchise unit exceeds $1 million. Maryland exempts franchises that require an initial investment of $750,000 or more from registration, but not from disclosure.

[757] *See also* Wieczorek, ANPR, 6Nov97 Tr, at 43 (suggesting that net wealth can be a proxy for experience).

[758] 64 Fed. Reg. at 37,321.

[759] *Id.*

[760] Marriott, Comment 35, at 6. *See e.g.,* Baer, Comment 11, at 16; Gurnick, Comment Comment 21, at 3; J&G, Comment 32, at 3.

with sophistication;[761] and (2) the exemption would offer little benefit to most franchisors.[762] Eric Karp, specifically, opposed the notion of using the investment amount or equity as a proxy for sophistication.[763] In his view, an "investment standard" does not consider the source of the prospective franchisee's funds:

> Did she re-mortgage her residence? Did he borrow from a friend or relative? Did they cash in their retirement fund? The investment standard also does not consider what other assets, liabilities, and income the prospective franchisee has from which one can estimate his or her financial sophistication and tolerance of risk.

Karp, Comment 24, at 7.

In lieu of the "investment" model offered by the Commission, Mr. Karp urged the Commission to consider SEC Regulation D, 17 C.F.R. §§ 230.501-508, as a model.[764] The SEC uses the concept of an "accredited investor," which is defined to include the following:

> A person whose individual net worth, or joint net worth with that person's spouse, at the time of the purchase, exceeds $1,000,000;
>
> A person with individual income of more than $200,00 over the previous two years, or joint income with that person's spouse of more than $300,000 in each of those years and has a reasonable expectation of reaching the same level of income in the current year; and
>
> An entity where all the equity owners are accredited investors.[765]

Mr. Karp asserted that the SEC approach "properly focuses on the qualifications of the investor, not the size of the investment." In his view, the NPR does the opposite. "The fact that a franchisee may be ready to invest a highly leveraged $1.5 million franchise investment does not prove that such a person is so sophisticated that a disclosure document would be of no benefit."

---

[761] Stadfeld, Comment 23, at 8; Karp, Comment 24, at 6.

[762] *Id*. *See also* NFA, Comment 27, at 3 (suggesting that the FTC "go the extra mile" to ensure that small, potential franchisees receive adequate information).

[763] Karp, Comment 24, at 6-7. *See also* Stadfeld, Comment 23, at 7-8 ("Being wealthy should not be a basis for being screwed.").

[764] *See also* Wendy's, Comment 5, at 2.

[765] *See* 17 C.F.R. §§ 230.501(5), (6), and (8).

Karp, Comment 24, at 8. Mr. Karp further noted that the accredited investor exemption is not a "carte blanche" to engage in an unlimited number of securities sales without registration. Rules 405 and 406 limit the aggregate dollar value of sales made to accredited investors to limits of $1,000,000 and $5,000,000 respectively. "The NPR places no limits on the number of franchises that can be sold under the proposed exemption." *Id*.

Finally, Mr. Karp discounted the potential benefit of the proposed large investment exemption to franchisors. According to Mr. Karp, the exemption would be of little benefit to the franchisor unless 100% of its franchise sales involved transactions over $1.5 million. If so, he insisted, there is no additional compliance burden imposed by requiring disclosures be given to all prospective franchisees because the franchisor has to prepare the disclosures in any event.[766]

After reviewing the comments, we continue to recommend that the Commission adopt a large investment exemption. Since the Rule's inception, the Commission has considered investment level as one indicia of sophistication. For example, in granting the Automobile Importers of America's petition for exemption from the Rule under Section 18(g), 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.

45 Fed. Reg. 51,763-64 (Aug. 5, 1980). Accordingly, we give great weight to prior Commission findings that a franchisee's level of investment is one indicium of sophistication.

More important, we believe that franchisors should have a bright-line standard that will clearly indicate when and under what circumstances the sophisticated investor exemption will apply. An exemption based upon the particular net worth of each individual prospective franchisee would be extremely burdensome to administer. For example, in some instances franchisors would not be able to take advantage of the exemption unless they first verified each prospective franchisee's financial information. Similarly, absent such verification, law enforcers would not be able to discern whether any specific franchise relationship was covered by the Rule. This approach would create a regulatory nightmare for both franchisors and franchise law enforcers.

---

[766] Karp, Comment 24, at 6. *See also* Bundy, ANPR, 6Nov97 Tr, at 21-22; Jeffers, *id.* at 23-24; Stadfeld, Comment 23, at 8.

We also reject Mr. Karp's conclusion that the proposed exemption may offer little benefit to franchisors. As a preliminary matter, there are franchise systems, such as lodging, where the typical franchise investment is likely to exceed whatever exemption threshold the Commission may adopt. Accordingly, the proposed large investment exemption would provide regulatory relief in those instances. Mr. Karp's concern will arise in instances where a franchisor typically sells outlets at levels below and above the threshold. We agree that franchisors in such instances must prepare disclosure documents in order to sell at levels below the threshold. According, the costs of providing disclosures to all franchisees, including those above the proposed threshold, may not be large. However, neither is the potential benefit. Indeed, the argument that sophisticated investors could benefit from disclosure misses the mark. The basis for the large investment exemption is not that "sophisticated" investors do not need pre-sale disclosure, but that they will demand and obtain material information with which to make an investment decision regardless of the application of the Rule. Where prospective franchisees are likely to obtain pre-sale material information by themselves, then the need for federal intervention is less compelling.

This view is also entirely consistent with the statutory approach set forth in Section 18(g) of the FTC Act, which gives franchisors the right to petition the Commission for a trade regulation rule exemption limited to a specific set of facts. Thus, a franchisor, if it wished, could petition the Commission for an exemption only for sales above a certain dollar figure. By analogy, the proposed large investment exemption need not be "all or nothing" to benefit franchisors. The very fact that franchisors almost uniformly supported the proposed large investment exemption would tend to confirm that it would provide them with some desired regulatory relief. Nonetheless, while we believe an exemption tied to the level of investment is appropriate, we propose further refinements based upon the comments. Below, we analyze these comments and offer our recommendations.

i. Proposed threshold

The NPR's proposed $1.5 million threshold was based upon the staff's examination of the costs to purchase more than 1,350 franchises listed in Enterprise Magazine's *The Franchise Handbook* (Spring 1998) ("*Franchise Handbook*). Very few franchises cost in excess of $1.5 million: the maximum estimated cost of establishing a franchise exceeds $1.5 million in just over 3% of the listed systems.[767] Rather, an investment of $1.5 million most likely would involve the purchase of several units. For example, more than 90% of the franchise systems listed have a maximum investment of less than $500,000. Thus, in order to qualify for the

[767] Where the listings in the *Franchise Handbook* provided data on the investment required, we used those figures. Where the *Franchise Handbook* provided no data, we sought data on the total investment from alternative sources, such as Entrepreneur Magazine's *Franchise 500* and the International Franchise Organization's *Franchise Opportunities Guide*. Even after consulting all three of these sources, we could not find data on the requirement investment for about 90 franchise systems.

proposed $1.5 million exemption, the investment would involve either the purchase of a single large franchise – such as a hotel or the most expensive restaurant location[768] – or the purchase of three or more units. As the Commission stated in the NPR, purchasers of multiple units are more likely to be persons with significant business experience in light of the management demands of operating multiple units.[769] We also assume that in many instances this universe of sophisticated investors will include existing franchisees with significant "hands-on" experience with the franchisor: these experienced investors are not likely to purchase a franchise on impulse, are more likely to negotiate over the terms of any contract, and are more resistant to high-pressure sales representations.

The NPR comments, however, reveal no consensus on whether a threshold of $1.5 million is most appropriate. For example, NASAA urged the Commission to increase the threshold to $3 million. In its view, $1.5 million may be inadequate because even unsophisticated investors may have access to $1.5 million to invest in a franchise.[770] Several commenters supported the $1.5 threshold, as proposed in the NPR.[771] Others believed that the threshold should be even lower.

McDonald's suggested that the threshold should be set at $1 million: "In our considerable experience, individuals purchasing franchises involving a $1 million investment have a clear understanding of the terms and conditions of the business arrangements and have obtained professional financial and/or legal advice before entering into the franchise agreement." McDonald's, Comment 7, at 2.[772] The IFA proposed a variation on this theme. It supported a $1 million threshold, excluding real estate costs. It observed that a 1997 update to the *Profile of Franchising* identified 52 franchise companies offering franchises with an initial investment

---

[768] Of the 12 restaurant systems listed in the *Franchise Handbook* with maximum investments of $1.5 million or above, all listed minimum investments to establish a location below the $1.5 million threshold, with three listing minimum investments of less than $1 million and seven estimating the minimum investment to be between $1 million and $1.2 million.

[769] 64 Fed. Reg. at 57,321.

[770] NASAA, Comment 17, at 12. Seth Stadfeld added that it is not difficult to invest $1.5 million when there is a down payment plus financing of a substantial portion of the investment. "Indeed, because they are taking on larger obligations, there is all the more reason and urgency why they should get the material, factual and contractual information that is otherwise available under the Rule." Stadfeld, Comment 23, at 8. *See also* NFA, Comment 27, at 3.

[771] *E.g.,* Baer, Comment 11, at 16; Gurnick, Comment 21, at 3; Marriott, Comment 35, at 6.

[772] *See also* 7-Eleven, Comment 10, at 3; NFC, Comment 12, at 20; BI, Comment 28, at 13. Wendy's suggested that the threshold be lowered, but did not offer any specific amount. Wendy's, Comment 5, at 2.

exceeding $1 million, excluding real estate. This equates to 4.4% or fewer of all franchise systems.[773]

PMR&W would lower the threshold to $500,000:

> [The $1.5 million] threshold essentially eliminates all but a very few franchised businesses, typically lodging facilities and perhaps the most expensive restaurant franchises. We suggest a $500,000 threshold as a more reasonable alternative based on the franchisee's likely resort to sophisticated advisory services from accountants and/or attorneys and the probable need for financing, and resulting due diligence oversight, from a financial institution.

PMR&W, Comment 4, at 3.[774]

We believe a $3 million dollar threshold would be too high, effectively restricting the exemption to only the rarest of instances, mostly large hotel franchises. On the other hand, the suggested $500,000 threshold, in our view, is too low. There is insufficient record support for the proposition that investors at the $500,000 level are sophisticated. We would rather err on the side of caution to ensure that prospective franchisees in need of the Rule's protection receive adequate disclosure. A harder decision is whether to retain the proposed $1.5 million threshold, reduce it to $1 million, or to $1 million excluding real estate costs. After further consideration, we recommend that the Commission adopt the $1 million excluding real estate costs, as proposed by the IFA.

In reviewing the NPR comments, we give considerable weight to the statements offered by franchisors such as McDonald's and Marriott that, in their experience, a $1 million investment is likely to involve sophisticated investors. At the same time, we share IFA's concern that the inclusion of real estate costs would tend to inflate the initial cost of a franchise investment, and perhaps such costs should be excluded from the threshold. As the IFA noted, a $1 million (excluding real estate) would encompass approximately 52 franchise systems, or under 5% of the universe of franchise systems. We also believe that the Rule should set forth a bright-line standard that can be readily applied across franchise systems. Rather than requiring a franchisor to calculate real estate costs in each offering, which could vary widely among franchised outlets

---

[773] IFA, Comment 22, at 7.

[774] *See* Cendant, ANPR 140, at 4 (suggesting the Commission adopt a $750,000 threshold exemption). H&H stated that the threshold should be lowered, but didn't offer a specific amount. H&H, Comment 9, at 4. Gary Duvall suggested a $250,000 threshold provided there is a showing that the purchaser, alone or with counsel, can understand the merits and risks of the investment. Duvall & Mandel, ANPR 114, at 21. We reject this suggestion as unworkable, because it would require franchisors to make subjective judgments about the purchasers' business acumen.

even in the same system,[775] we would prefer a single, clear threshold. Accordingly, we believe that the proposed $1 million, excluding real estate, would strike the appropriate balance.

ii. Meaning of "investment"

Several commenters voiced concerns about how the investment threshold should be calculated. For example, J&G questioned: " Is it the initial investment described in Item 7? Is it the amount of the investment over the term of the franchise? Or is it some other calculation?" J&G, Comment 32, Attachment, at 6. The NFC voiced similar concerns and urged the Commission to clarify the term "investment" to mean the franchisee's estimated investment, as set out in Item 7 of the disclosure document.[776]

Others raised alternative calculation approaches. For example, Wendy's observed that the NPR, by focusing on investment, "exclude[s] those expenses to be incurred during the first three months of operation which are not offset by sales. . . . [This] artificially raises the threshold." Wendy's, Comment 5, at 2. Similarly, J&G urged the Commission to include all commitments for real property over the life of the contract, not just mortgage or lease payments for the first few months.[777]

H&H and the NFC would revise the Rule to make clear that the threshold includes the total projected investment, whether in single- or multiple-unit transactions. As the NFC noted: "A multi-unit franchisee investing the threshold amount (or more) in a number of units is just as sophisticated as another franchisee investing a like amount in a single unit." NFC, Comment 12, at 21.[778]

Several commenters also urged the Commission to include in the threshold prior investments made in a conversion franchise and investments made through transfers. For example, H&H stated that the term "'investment' should include the fair market value of an existing facility as part of the investment, so as to include an existing facility that is being

---

[775] We noted that the UFOC Guidelines recognize the difficulty of determining real estate costs in advance. For example, the Item 7 Sample Answer addressing real estate provides a range of rents ($12,000-20,000) "depending on factors such as size, condition, and location of the leased premises." UFOC Guidelines, Item 7, Sample Answer at note 2.

[776] NFC, Comment 12, at 20. *See also* Marriott, Comment 35 at 6 ("'Investment' for purposes of the exemption should be defined as the initial investment as set forth in Item 7, plus credit extended by any lender and commitments for real property (not just mortgage or lease payments for the first few months.").

[777] J&G, Comment 32, at 4.

[778] *See also* H&H, Comment 9, at 4.

converted to the franchise system." H&H, Comment 9, at 4.[779] In a similar vein, the NFC questioned whether a transfer of a franchise can qualify for the exemption. It urged the Commission to include in the proposed exemption's "investment" requirement a transfer, where the franchisee pays an existing franchisee the threshold amount and then enters into a new franchise agreement with the franchisor. "[W]e . . . submit that franchisees making such an investment prior to the execution of the subject franchise agreement are as 'sophisticated' as their brethren who make the investment after executing that agreement." NFC, Comment 12, at 21.

For the following reasons, the staff recommends that the Commission use the Compliance Guides to explain in greater detail what constitutes an "investment" for purposes of the large investment exemption. We begin our analysis by rejecting the suggestion offered by several commenters that the Commission adopt a very broad definition of the term "investment" that would include post-sale expenses. We are convinced that the threshold should be determined by the investment made at the time of sale. It is not farfetched to assume that a large universe of franchisees investing $100,000 or less today might actually pay to the franchisor more than $1 million (excluding real estate) during the course of a lengthy franchise agreement, especially when we consider royalty and advertising fees, as well as ongoing product purchases. For that reason, a broad large investment exemption would effectively eviscerate the Rule's protection.

Nonetheless, we agree that the definition of initial investment could be broadened without sacrificing necessary investor protection. First, the investment threshold should apply to both single-unit and multiple-unit transactions. We believe that was the Commission's intention when drafting the NPR. The total level of the prospective franchisee's investment, not the number of units purchased, is the primary factor underlying the proposed exemption. As noted above, purchasers of multiple units are likely to be current owners or otherwise sophisticated buyers.

Further, we agree that the Commission should clarify how the exemption will apply to conversions and transfers of franchised units. We recommend that once an individual qualifies as a sophisticated investor, he or she remains "sophisticated" if converting its unit to a franchise system. Indeed, a strong argument can be made that a conversion franchisee is even more sophisticated than a new franchisee, having worked in the business for a period of time. Similarly, we see no reason why a prospective franchisee cannot qualify as a sophisticated investor if purchasing his or her outlet through a transfer. The fact that a transferee will assume an existing contract or may renegotiate an existing contract with the franchisor should have no

---

[779] A conversion franchise occurs when existing, independent businesses decide to associate with a franchise system. The NFC noted that conversion franchise activity is the "dominant form of franchise activity extant in the guest lodging and real estate brokerage arenas, and is common in other sectors as well. While new construction of franchised hotels does transpire, much franchising activity in the guest lodging sector involves the conversion of existing hotels . . . to the name, mark, and system of a guest lodging franchisor." NFC, Comment 12, at 20. *See also* PREA, Comment 20, at 3; Marriott, Comment 35, at 6.

bearing on his level of sophistication as an investor, as long as he or she can satisfy the threshold. In short, we recommend looking at the total investment made in acquiring the franchise, not just the investment made when the franchisee signs the franchise agreement, in determination the application of the large investment exemption.[780]

At the same time, we recommend that the Commission narrow the term "investment" in one respect. Specifically, we are troubled by the issue of investors pooling their resources to satisfy the threshold. Clearly there is a significant difference between a single individual purchasing a franchise for $1 million, versus a group of 10, for instance, each contributing $100,000. Obviously, the larger the group of investors, the smaller each individual investor's financial risk may be. In such a circumstance, there is no reasonable assurance that each investor will be sophisticated. We would propose, therefore, that the exemption apply only if at least one individual in the investor-group qualifies as "sophisticated" by investing at the threshold level.[781]

iii. Offers of franchisor financing

As noted above, the NPR proposed excluding from the proposed $1.5 million threshold any sums financed by the franchisor or an affiliate.[782] The Commission explained that this exclusion would add a measure of protection to the prospective franchisee because traditional lenders are more likely than the franchisor to require a due diligence investigation of the offering.[783]

J&G and Marriott opposed the exclusion of franchisor-extended credit from the proposed threshold. For example, Marriott asserted that it does not believe that there are inherent risks that would justify excluding financing from the franchisor. Indeed, it feared that the proposal might have the unintended effect of harming franchisees by discouraging franchisors from offering financing to prospects in order to qualify for the exemption.[784] At the same time, Eric Karp disputed the view expressed in the NPR that lenders may act as an effective check, requiring a

---

[780] Accordingly, the large investment exemption would be available not only for conversion franchises, but where an existing franchisee switches brands (such as a Hilton becoming a Marriott) or where a non-franchised, independent business (such as an unaffiliated real estate agent) becomes affiliated with a real estate franchise system, such as ReMax.

[781] This proposal is similar to the concept in SEC Regulation D where an entity can qualify as an accredited investor if all the equity owners are accredited investors. *See* Karp, Comment 24, at 8.

[782] 64 Fed. Reg. at 57,321.

[783] *Id.*

[784] Marriott, Comment 35, at 6. *See also* J&G, Comment 32, at 4;

prospect to have sufficient equity capital before granting a loan.[785] He contended that there is "no support in the record as to what amount of equity a bank might require on a franchise investment of $1.5 Million." Karp, Comment 24, at 7.

The staff recommends that the Commission continue to exclude franchisor-extended credit from the large investment threshold. We are convinced that this exclusion will ensure better protection against fraud. Otherwise, a franchisor could be tempted to increase the cost of the initial investment to qualify for the large investment exemption, only to turn around and offer to finance the deal himself, all without proper pre-sale disclosures. In that regard, we agree with Mr. Karp who observed that the assumption that a prospective franchisee will have a sufficient level of equity tends to disappear "where a franchisee obtains financing from the franchisor or its affiliates or from a selling franchisee; in such instances, far less equity may be required." Karp, Comment 24, at 7.

Further, it is reasonable to assume that a lender, in order to minimize its own financial risk, will ensure that a prospective franchisee will conduct a due diligence investigation of the franchise offering. Indeed, by involving a lender, the prospective franchisee effectively ensures that there is an independent, sophisticated entity inserted into the sales process. This additional safeguard would be lost if sources of financing for purposes of the exemption included the franchisor and its affiliates.

iv. Acknowledgment

In the NPR, the Commission proposed that prospective franchisees sign an acknowledgment if they are not receiving disclosures because their investment satisfies the large investment exemption. This would reduce the opportunity for fraud by enabling the prospect to verify that the investment meets or exceeds the exemption threshold.[786]

Several commenters either did not understand the purpose of the acknowledgment or believed that it would serve no useful purpose. For example, BI stated: "We do not understand the purpose or the importance of the acknowledgment by the prospective franchisee of the application of the exemption. The acknowledgment does not protect the prospective franchisee, except, perhaps to put the prospect on notice that it may be entitled to receive a disclosure document." BI, Comment 28, at 13.

Seth Stadfeld told us that the acknowledgment could be abused. "[F]ranchisors could further a fraud by playing up to and flattering the prospective franchisee into thinking that he is so sophisticated that he doesn't need the disclosures that the little people need." Stadfeld, Comment 23, at 8. On the other hand, Howard Bundy advised that the acknowledgment should

---

[785] *See* 62 Fed. Reg. at 57,321 and n.255.

[786] 64 Fed. Reg. at 57,321.

be expanded. He would revise the Rule to read: "The franchisee's estimated investment, excluding any affiliate financing, totals at least $1.5 million and the prospective franchisee signs an acknowledgment stating the basis for the exemption from the Rule and providing the CFR citation to the Rule and verifying the grounds for the exemption . . . ." Bundy, Comment 18, at 14.

We recommend that the Commission retain, but revise, the acknowledgment requirement proposed in the NPR. As previously noted, the acknowledgment will ensure that a prospective franchisee receives notice that the transaction is exempt from the Rule. This would tend to prevent fraud by enabling the prospective franchisee to verify the applicability of the exemption. Further, we believe that abuse of the acknowledgment requirement is unlikely. The acknowledgment is not a waiver: either the prospective franchise sale is covered by the Rule or it is exempt. Thus, any flattering statements made by a franchisor have no bearing on the franchisor's core obligation to furnish disclosures.

At the same time, we agree with Mr. Bundy that the acknowledgment should reference the Franchise Rule itself. This would enable a prospective franchisee to review the Rule, understand the exemption, and, ultimately, verify the exemption's application. Finally, the acknowledgment needs to be modified to reflect our proposed revised exemption threshold – $1 million excluding real estate costs. Accordingly, we recommend that the Commission adopt the following acknowledgment: "The franchise sale is for more than $1 million, excluding real estate costs, and thus is exempted from the Commission's Franchise Rule disclosure requirements, pursuant to 16 C.F.R. § 436.8(a)(5)(i)."

d. Proposed section 436.8(a)(5)(ii): Large franchisee exemption

In the NPR, the Commission further proposed exempting from the Rule franchise sales to large entities; namely, those who have been in business for at least five years and have a net worth of at least $5 million.[787] For example, a fast food franchisor may sell a number of franchised outlets to a hotel chain. Such transactions often are heavily negotiated by sophisticated counsel who have significant experience in the franchise industry. Even if a large entity does not have prior experience specifically in franchising, it is reasonable to assume that it can nevertheless protect its own interests when negotiating a franchise purchase.[788]

---

[787] 64 Fed. Reg. at 57,321. No state has a comparable disclosure 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." 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, ANPR 114, at 3-4.

[788] *See* Kaufmann, ANPR, 18Sept97 Tr, at 190.

The staff believes that an exemption for large franchisees is a logical extension of the Rule's current exemptions. The closest analogous exemption is the fractional franchise exemption. That exemption, however, is very narrowly tailored, focusing only on persons who wish to expand their existing product lines, have two years of *related* experience, and face a minimal financial risk.

The following illustrates the need to supplement the fractional franchise exemption with the proposed large investor exemption. In 1997, the staff was asked for an advisory opinion on whether a travel services company would be covered by the Rule if it sold outlets to hospitals. The only possible exemption in the Rule that could apply is the fractional franchise exemption. The staff advised that the hospital could not qualify as a fractional franchisee under the Rule, however, because it did not have the requisite two years of experience in providing travel-related services.[789] Hospitals and other large institutions such as airports and universities are hardly the type of "consumers" that the Commission needs to protect.[790]

i. Entities covered by the exemption

In the NPR, the Commission proposed that the large franchisee exemption be limited to corporations. Many commenters supported the proposed exemption, but criticized its narrow application.[791] Specifically, several commenters urged the Commission to consider exempting other large entities, such as partnerships, finding no rationale for restricting the exemption only to corporations. We agree.

We recommend, therefore, that the Commission broaden the proposed exemption to include other business entities, such as partnerships. Specifically, we recommend that the Commission revise the proposed exemption to use the word "entity," while making clear in the Compliance Guides that the exemption covers corporations, partnerships, and similar business arrangements.[792]

---

[789] Advisory 97-7, Bus. Franchise Guide (CCH) ¶ 6,487 (1997).

[790] *See* Kirsch, ANPR, 18Sept97 Tr, at 198-99. *But see* Kezios, *id.* at 191-92 (opposing exemption for large institutions, suggesting that they need franchise advice and counsel as well).

[791] *E.g.,* IL AG, Comment 3, at 2; PMR&W, Comment 4, at 3; Wendy's, Comment 5, at 3; Triarc, Comment 6, at 1; H&H, Comment 9, at 5; Baer, Comment 11, at 16; NFC, Comment 12, at 22; BI, Comment 28, at 14; Tricon, Comment 34, at 7; Marriott, Comment 35, at 7.

[792] As a practical matter, the large franchisee exemption would also apply to individuals who purchase franchises. Any sophisticated investor who has been in business for at least five years and has generated an individual net worth of over $5 million would likely form a corporation or other entity in which to conduct business. Indeed, any individual with the requisite experience and net worth who attempted to conduct business without insulating him or herself from

ii. Net worth and prior experience

As proposed in the NPR, the large franchisee exemption would require both a threshold net worth ($5 million), as well as prior experience (five years). Several franchisor advocates told us that the proposed exemption's net worth and prior experience prerequisites are overly restrictive. Some commenters would focus on net worth as the appropriate measure of sophistication, while others would focus on prior experience.

The NFC, for example, asserted that net worth alone is sufficient to determine sophistication: "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." NFC, Comment 12, at 21-22.[793] The NFC has offered the following proposed revised language:

> . . . the franchisee is an organized business entity (including, without limitation, a corporation; limited partnership; limited liability company; general partnership; or a functional equivalent) that has a net worth of at least $5 million dollars or is an affiliate (as defined in § 436.1[(b]) of such an officially recognized business entity.

NFR, Comment 12, at 23.

H&H, however, contended that a $5 million net worth threshold is too high, limiting the exemption to a small number of publicly-traded companies. "Many successful private companies do not seek to accumulate equity, but instead to maximize cash flow to their owners. Thus, such a high net worth requirement would prevent the exemption of many sophisticated investors." H&H, Comment 9, at 5. The firm would set the net worth requirement at $1 million. *Id*. On the other hand, Howard Bundy asserted that the $5 million net worth requirement is too low, sweeping in many very small companies. "That is a small enough net worth to not be indicative of the level of sophistication that would indicate no need for mandatory disclosures." Bundy, Comment 18, at 14.

In lieu of net worth, Triarc argued in favor of prior experience as the determining factor. It noted that it is possible that a franchisee with 10 years of experience and 50 units may wish to finance its operation with debt rather than equity. Under the circumstances, this presumably sophisticated franchisee would fail the net worth test:

---

potential liabilities may in fact rebut our presumption that such an individual is a sophisticated investor and, therefore, should receive appropriate disclosures.

[793] Similarly, J&G maintained that any "entity or group of entities with a $5 million or more net worth should, by definition, be deemed to have the requisite sophistication to satisfy the exclusion or exemption." J&G, Comment 32, at 4.

> What if a large corporate franchisee with $20.0 million of net worth declares a $16.0 million dividend to its shareholders or otherwise does a recapitalization which takes its net worth below the threshold? Over the years, some gigantic companies that are financially healthy have had huge negative net worths and negative earnings. . . . We would suggest that net worth is often an indicator of how a company chooses to finance itself rather than of sophistication.

Triarc, Comment 6, at 2.

Finally, a few commenters told us that the proposed exemption prerequisites ($5 million net worth and five years of experience) would essentially disqualify new corporations. They asserted that there are legitimate tax and liability reasons why an experienced franchisee may wish to establish a separate corporation for a particular franchise transactions. For example, according to Marriott, it is not unusual in the lodging and restaurant industries to form "special purpose entities (SPEs) . . . to insulate either a parent company or the individual investors from liability." Marriott, Comment 35, at 7. If so, then it might be impossible for such new corporations to satisfy the proposed exemption's criteria.[794] These commenters urged the Commission to consider the consolidated net worth and experience of franchisee affiliates.[795]

After considering the arguments supporting and opposing the net worth and prior-experience prerequisites, we conclude that the Commission should retain both prerequisites, with one modification. We believe that net worth and prior-experience are necessary elements to ensure that the Rule continues to protect businesses with limited experience, limited assets, and, by inference, limited prior success. For example, a small sandwich shop franchisee is not necessarily sophisticated enough to purchase a hotel merely because the franchisee has operated one or more units for five years. Similarly, several wealthy individuals who form a partnership without any prior *business experience* are not necessarily sophisticated merely because of their net worth. Nonetheless, we agree with the commenters who have observed that the net worth and prior experience prerequisites may not make sense when applied to franchisee spin-off subsidiaries or affiliates that are formed primarily for tax or limited-liability purposes. Accordingly, we recommend that the Commission permit the aggregation of commonly-owned franchisee assets in determining the availability of the large entity exemption:[796]

---

[794] *See also, e.g.,* NFC, Comment 12, at 22; J&G, Comment 32, at 4; H&H, Comment 9, at 5. Triarc, for example, noted that one Arby's franchisee owns 700 units and is one of the largest privately owned restaurant operators in the world. It asked "why should we have to give disclosure to that franchisee merely because he sets up a new corporate entity to own his next Arby's store?" Triarc, Comment 6, at 1-2.

[795] NFC, Comment 12, at 22; J&G, Comment 32, at 4; H&H, Comment 9, at 5.

[796] To that end, we also recommend modifying the definition of "affiliate" to cover both franchisee and franchisor affiliates, as noted in our discussion of the proposed definitions above.

The franchisee (and its parent and any affiliates) is an entity that has been in business for at least five years and has a net worth of at least $5 million.

e. Proposed section 436.8(a)(6): Officers, owners, and managers exemption

The NPR further proposed exempting from the Rule franchise sales to franchisees who are (or recently have been) officers or owners of the franchisor.[797] 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. Indeed, in some instances, a company may wish to offer units to its owners or officers only. If not exempt from the Rule, 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, however, the proposed exemption is limited to individuals who have been associated with the franchisor within 60 days of the sale and who have been involved for at least two years with the franchise system.

The NPR proposal generated four comments. The NFC and AFC endorsed the proposed exemption, although the NFC encouraged the Commission to broaden it to include "trustees, general partners and any individual who has or had management responsibility for the offer and sale of the franchisor's franchises or the administration of the franchised network." NFC, Comment 12, at 23.[798] This would make the exemption parallel to Item 2. Seth Stadfeld, however, questioned the need for the exemption if the franchisor is already providing disclosures to others.[799] Howard Bundy urged the Commission to limit the exemption to *bona fide* officers, fearing that a franchisor could attempt to skirt disclosure obligations by putting a prospective franchisee on the board of directors, for example, for a few days or weeks before the sale and removing him or her shortly thereafter.[800]

Based upon the record, the staff recommends that the Commission broaden the proposed exemption. Specifically, we agree with the NFC's suggestion that the exemption should cover not just owners and officers of a franchise system, but others with direct management experience. It is reasonable to assume that managers and others with at least two years of direct experience in

---

[797] 64 Fed. Reg. at 57,322. The proposed exemption is modeled after nearly identical language in California's statute. Washington and Rhode Island have similar exemptions. *See* Duvall & Mandel, ANPR 114, at 21 (suggesting a narrower approach).

[798] *See also* AFC, Comment 30, at 3.

[799] Stadfeld, Comment 23, at 9.

[800] Bundy, Comment 18, at 14.

the franchise system should be well-informed about the operation of that particular system. Where a non-franchised company wishes to sell a limited number of outlets to experienced company personnel only, it would be overly burdensome to force the company to create a disclosure document when the only beneficiaries of the disclosures are already knowledgeable individuals. We also note that the proposed exemption is franchise-specific. We do not mean to suggest that a manager of one company is deemed sophisticated for all franchise sales. Rather, the exemption would apply only to a manager or other officer seeking to purchase a franchise of that very company. So revised, the exemption could apply when:

> One or more purchasers of at least a 50 percent ownership interest in the franchise: (1) within 60 days of the sale, has been, for at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor's franchisees or the administrator of the franchised network; or (2) within 60 days of the sale, has been, for at least two years, an owner of at least a 25 percent interest in the franchisor.

We also recognize Mr. Bundy's concern that franchisors may abuse the exemption in an effort to skirt the Rule. Nonetheless, we believe that this concern has been addressed in the proposed exemption's prerequisites. In order to qualify for the exemption, the prospective franchisee must have served one of the enumerated positions for at least two years. Moreover, their relationship with the franchisor must be current: within 60 days of the sale. These prerequisites are likely to ensure that the prospect is in fact a *bona fide* officer or owner.

4. Proposed section 436.8(b): Inflation adjustment

In the NPR, the Commission proposed publishing revised thresholds for the sophisticated investment exemptions once every four years to adjust for inflation.[801] A four-year adjustment

---

[801] 64 Fed. Reg. at 57,321-22. The proposal to adjust thresholds for inflation is modeled after the Appliance Labeling Rule, 16 C.F.R. Part 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 that rule's labeling requirements. Specifically, 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." This approach 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. In addition, under the Debt Collection Improvement Act of 1996, the Commission adjusted civil penalty amounts from $10,000 to $11,000 to account for inflation. Those amounts must be adjusted at least once every four years. *See* 61 Fed. Reg. 54,549 (Oct. 21, 1996).

would be sufficient to ensure that the thresholds keep up with inflation, while relieving the Commission of the expense and burden of more frequent adjustments.

The NPR's inflation adjustment proposal garnered three comments. PMR&W agreed with the need for a threshold adjustment outside of the normal rulemaking process. John Baer supported the proposal as published in the NPR.[802] The NFC offered a slightly different approach. It suggested that the Commission tie the thresholds amount automatically to reflect increases in the Consumer Price Index, while placing the burden on the franchisor to prove that it qualified for the exemption at the time in question.[803]

We are persuaded that the Commission needs a simplified mechanism to adjust the sophisticated investor exemption thresholds for inflation quickly without the burdensome rulemaking amendment procedures. We believe the Rule should contain bright-line thresholds that are clear to both franchisor and franchisee alike. Thus, any adjustments to Rule thresholds should be imposed only after proper notice to the public, where the effective date of the adjustment and the adjustment amount are clear. We believe the most effective way to provide such notice is through periodic *Federal Register* announcements of adjustments based upon the Consumer Price Index. Finally, although not addressed in the NPR, we believe the period inflation adjustment should also pertain to the minimum payment exemption, currently set at $500.[804]

5. Exclusions

Finally, as noted above, the NPR proposed streamlining the Rule by eliminating the four current Rule exclusions for non-franchise relationships.[805] In the SBP, the Commission explained that these four relationships are *not* franchises, but might be perceived as falling within the definition of a franchise.[806] To avoid any confusion, the Commission expressly excluded these four relationships from Rule coverage. In the NPR, the Commission expressed the view that clarifying exclusions are no longer necessary. Nonetheless, to ensure that no one misinterprets the proposed elimination of the exclusions as signaling a substantive change in Commission policy, the Commission made clear that it continues to believe that these four

---

802 Baer, Comment 11, at 16.

803 NFC, Comment 12, at 22.

804 *See, e.g.,* H&H, Comment 9, at 4; Baer, Comment 11, at 15-16.

805 64 Fed. Reg. at 57,319. *See* n.58 above.

806 43 Fed Reg. at 59,708.

relationships are not covered by the Rule, and that their elimination is simply part of the Commission's general streamlining effort.[807]

Several commenters opposed the elimination of the four Rule exclusions. J&G stated that businesses that have relied on these exclusions, and that lawyers advising clients and courts asked to interpret the proposed Rule might find the exclusions useful.[808] Similarly, John Baer asserted that dropping the exclusions is likely to be misinterpreted and cause confusion over the extent of Rule coverage.[809] For example, TruServ, a hardware retailer cooperative, believes that there should be a clear distinction between cooperatives and franchises and urged the Commission to retain the exclusion for cooperatives.[810]

For the reasons stated in the NPR, the staff recommends that the Commission remove the current Rule's four exclusions, as proposed. Nonetheless, we recognize that the exclusions may still serve a useful purpose, explaining to practitioners the distinctions between business arrangements that may appear to be franchises. However, we are convinced that the proper place for such an explanation is in the Compliance Guides that will accompany the revised Rule.

X. PROPOSED SECTION 436.9: ADDITIONAL PROHIBITIONS

A. Background

We next turn to the prohibitions section of the proposed revised Rule. As noted in the NPR, the Commission proposed retaining the current Rule prohibitions against the making of statements that contradict the franchisor's disclosures,[811] failing to make promised refunds,[812] and

---

[807] As in other areas of Rule interpretation, the staff can address future questions concerning the definition of the term "franchise" on a case-by-case basis through informal advisory opinions.

[808] J&G, Comment 32, Attachment, at 9.

[809] Baer, Comment 11, at 15. *See also* IL AG, Comment 3, at 3; PMR&W, Comment 4, at 3; H&H, Comment 9, at 3; Gurnick, Comment 21, at 7.

[810] TruServ, Comment 33, at 2.

[811] 64 Fed. Reg. at 57,322. *See also* 16 C.F.R. § 436.1(f). "Without this provision, the Commission believes that the disclosures required by the rule could be contradicted in oral sales presentations and rendered of little value without violating the rule." SBP, 43 Fed. Reg. at 59,695.

[812] 64 Fed. Reg. at 57,346. *See also* 16 C.F.R. § 436.1(h). In the SBP, the Commission observed that numerous consumers complained about the difficulty they experienced when they attempted to obtain refunds from their franchisors. "It is clear from the record that all franchisors

failing to make available written substantiation for financial performance representations.[813] Few comments were submitted on these proposed prohibitions, and we recommend that the Commission retain them in the final revised Rule, with one modification. With respect to financial performance representations, it may be unreasonable to expect non-franchisor sellers to possess documentation for the franchisor's representations. Accordingly, we recommend that the Commission make clear in the Compliance Guides that a franchise seller can satisfy his or her obligation to furnish financial performance substantiation by promptly referring any request for such information to the franchisor.

The NPR also proposed adding three new prohibitions concerning: (1) the use of "shills;"[814] (2) the use of contract integration clauses;[815] and (3) the making of financial performance representations outside of a disclosure document.[816] Other than the comments already addressed in the definitions section, no comments were submitted on the proposed financial performance prohibition.[817] Accordingly, we recommend that the Commission adopt it in the final revised Rule.[818] In the following section, we discuss the shill, integration clause, and refund issues.

---

do not adequately adhere to the refund policies they themselves agree to in their contracts." 43 Fed. Reg. at 59,696-97. *See also* Staff Review at 29 (some franchisees continue to experience problems with obtaining refunds).

[813] 64 Fed. Reg. at 57,332. *See also* 16 C.F.R. §§ 436.1(b)(2) and (c)(2); UFOC Item 19. In the SBP, the Commission rejected the idea that franchisors should always leave a copy of their financial performance substantiation with the prospective franchisee. At the same time, it found that "the benefit to be derived from permitting those prospective franchisees who so wish to review the franchisor's substantiation far outweigh speculative harms that could arise from such disclosure." 43 Fed. Reg. at 59,691.

[814] 64 Fed. Reg. at 57,323-24.

[815] *Id.* at 57,323.

[816] *Id.* at 57,322-23.

[817] The only comments submitted on the proposed financial performance claim prohibition concerned whether general media should include the Internet. We have already addressed this issue at length in our discussion of the definition of "financial performance representation" in the definitions section above. For the reasons stated in that section, we recommend that the Commission limit electronic financial performance claims to those aimed specifically at prospective franchisees.

[818] At the same time, we recommend that any performance claim also state the dates when the reported level of financial performance was achieved, consistent with the current Rule. *See* 16 C.F.R. 436.1(e).

B. The Record and Recommendations

1. Proposed section 436.9(b): Shills

The NPR proposed prohibiting franchise sellers from using phony references or "shills."[819] Specifically, franchise sellers would be barred from misrepresenting that any person has actually purchased or operated one of the franchisor's franchises and 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[820] shows that shills are often the glue that holds a scam together by allaying consumers' concerns about the investment risks.[821]

The proposed anti-shill provision generated only one comment. J&G expressed concern that actors or public figures used in a franchisor's advertising campaigns "will need to exercise caution when making endorsements of franchises so as not to run afoul of prohibitions against misrepresenting that they are able to provide 'an independent and reliable report about the franchise or the experiences of any current or former franchisees.'" J&G, Comment 32, Appendix, at 9.

There is no evidence in the record on the extent to which franchisors use actors or public figures to sell franchises, as opposed to selling products and services to the end-user. Based upon our experience, we believe such practices are rare. More important, our primary concern is with deception: we see little difference between a franchisor paying unknown individuals to deceive prospective franchisees, on the one hand, and paying actors or celebrities to deceive prospective franchisees, on the other. In each case, a franchisor should not be able to pay

---

[819] The proposed anti-shill prohibition is also broad enough to cover the use of "institutional shills," companies that purport to act like a Better Business Bureau that provide consumers with independent reports on its members. *See FTC v. United States Bus. Bureau*, Bus. Franchise Guide (CCH) ¶ 10,865 (S.D. Fla. 1995).

[820] Scam artists may use shill references in order to bolster their financial performance and success claims. *E.g., Car Checkers of Am.,* Bus. Franchise Guide (CCH) ¶ 10,163, at 24,04. *See also FTC v. Hart Mktg. Enter.,* No. 98-222-CIV-T-23 E (M.D. Fla. 1998); *FTC v. Unitel Sys., Inc.,* No. 3-97CV1878-D (N.D. Tex. 1997); *FTC v. Southeast Necessities Co., Inc.,* Bus. Franchise Guide (CCH) ¶ 10,526 (S.D. Fla. 1994).

[821] The NCL reported that complaints about fake references are among the most common franchisee and business opportunity complaints it receives. NCL, ANPR 35, at 2. *See also* Staff Program Review at 39 (showing that false or deceptive representations pertaining to testimonials and references is the second most common Section 5 allegation (28 counts) in Commission business opportunity and franchise cases).

individuals to lie about their purported experience in order to lure unsuspecting consumers to buy a franchise.[822] We conclude that the NPR's proposed anti-shill prohibition is entirely proper.

2. Proposed Section 436.9(i): Disclaimers and contract negotiations

In the NPR, the Commission proposed prohibiting franchise sellers from disclaiming or requiring "a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments." 64 Fed. Reg. at 57,323. At the same time, the Commission expressed concern that prohibiting franchise sellers from disclaiming or waiving the contents of a disclosure document could have the unintended consequence of chilling the negotiation of franchise agreement terms and conditions. Arguably, a franchisor could not negotiate franchise terms – such as the cost and expiration date – if a prospective franchisee may not waive the original terms set forth in the disclosure document. To avoid such a result, the Commission proposed that a prospective franchisee could agree to different terms if the franchisor identifies the changes, the prospective franchisee initials the changes, and the prospective franchisee has five days to review the revised contract before signing it or paying a fee.[823]

a. Integration clauses and waivers

During the ANPR proceeding, several franchisees and their representatives asserted that franchisors routinely seek to disclaim liability for their pre-sale disclosures through the use of contract integration clauses. Through these clauses, franchisees effectively waive any rights they may have to rely on pre-sale disclosures made to them during the sales process. For example, Peter Lagarias, a franchisee advocate, told us:

> In virtually every lawsuit I have filed for franchisees alleging fraud, franchise disclosure, or unfair or deceptive practices (under California law since the FTC

---

[822] We further note that this view is consistent with the Commission's Guides Concerning The Use of Endorsements and Testimonials In Advertising, 16 C.F.R. § 255. These guides require that any representation in an ad that purports to represent the view of a consumer must, in fact, reflect the consumer's actual views or experience:

> Endorsements must always reflect the honest opinions, findings, beliefs, or experience of the endorser. Furthermore, they may not contain any representations which would deceive, or could not be substantiated if made directly by the advertiser.

Id. at § 255.2(a). Therefore, any actor or public figures who might run afoul of this provision in the Franchise Rule already risks being found in violation of the FTC Act.

[823] *Id.*

> 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.

Lagarias, ANPR 125, at 4.[824] Another franchisee representative, Andrew Selden, added that integration clauses are "not well understood and their impact is not appreciated at all until long after the franchise purchasing commitment is made." Selden, ANPR 133, Appendix B, at 2.

In response to the ANPR comments, the Commission proposed in the NPR that the Rule prohibit franchise sellers from disclaiming liability for statements made in a disclosure document, as well as from requiring a prospective franchisee to waive reliance on any disclosure document representations.[825] This generated significant comment, both supporting and opposing the proposal.

Several franchisee advocates and state regulators supported the proposed prohibition on integration clauses. The IL AG, for example, asserted that this proposal would be a valuable addition to the Rule, noting that franchisees signing a franchise agreement may have no idea that they are waiving reliance on the disclosure document.[826] Similarly, the AFA stated:

> The integrity of a franchisor's disclosure document is critical to prospective franchisees. The prevalent use of integration clauses to disclaim liability for required disclosures undermines the very purpose of the Rule, which is to prevent fraud and misrepresentation in the pre-sale process by ensuring prospective franchisees have complete and truthful information from which to make sound investment decisions.

AFA, Comment 14, at 6. NASAA was in full agreement: "Based on the law enforcement experience of franchise registration states, the vast majority of franchise agreements contain some type of waiver or integration provision purporting to insulate franchisors from liability for

---

[824] *See also, e.g.,* Manuszak, ANPR 13; Bell, ANPR 30; Sibent, ANPR 41 (and 19 identical ANPR comments); AFA, ANPR 62, at 3; Bundy, ANPR 119, at 2; Zarco & Pardo, ANPR 134, at 3.

[825] 64 Fed. Reg. at 57,323 and 57,346.

[826] IL AG, Comment 3, at 6; IL AG Rebuttal, Comment 38, at 3.

oral or other representations that conflict with the required disclosure document or franchise agreement." NASAA, Comment 17, at 12.[827]

A few commenters support, but would expand, the proposal. Howard Bundy, for example, would prohibit franchisors from disclaiming liability for statements also made in their written marketing material.[828] Seth Stadfeld would ban integration clauses in franchise agreements altogether. He asserted that such clauses are "the single greatest tool used by franchisors to evade responsibility for misrepresentations and omissions of material facts that take place in a franchise marketing program." Stadfeld, Comment 23, at 9-10.[829]

Franchisors, on the other hand, either opposed the proposed disclaimer prohibition or would limit the prohibition's scope. Several franchisors strongly asserted that integration clauses are necessary for two purposes. As J&G explained, franchisors have to be able to rely on the final franchise agreement as the manifestation of the intent of the parties. In addition, franchisors must be able to disclaim liability for unauthorized statements made by rogue salesman, such as unauthorized earnings claims. The firm advised that the proposal fails to explain how franchisors may lawfully protect themselves without using "the merger and integration clause [the Commission] proposes to ban." J&G, Comment 32, at 4-5.[830]

Franchisors also suggested that the proposed anti-disclaimer provision is unnecessary. According to John Baer, for example, the Commission could always take action if a franchisor's disclosure document contains false information.[831] In the same vein, J&G asserted that the basis for the proposal is that integration clauses may deny a franchisee a remedy when franchisees litigate against franchisors. The firm noted, however, that only the FTC is authorized to bring a claim for violation of the Franchise Rule; the Commission's ability to address false representations in a disclosure document will survive any integration clause between the franchisor and franchisee.[832]

---

[827] *See also* Karp, Comment 24, at 22-23; NFA, Comment 27, at 2; Morrill, Comment 31, at 1-2.

[828] Bundy, Comment 18, at 14. *See also* IL AG, Comment 3, at 6.

[829] In the alternative, Mr. Stadfeld suggested that the cover sheet contain an explicit warning that anything stated by the franchisor that is not in the contract should not be relied upon in any way. Stadfeld, Comment 23, at 10.

[830] *See also* Marriott, Comment 35, at 8; GPM Rebuttal, Comment 40, at 10-11.

[831] Baer, Comment 11, at 16-17.

[832] J&G, Comment 32, at 4-5. *See also* Marriott, Comment 35, at 7-8.

PMR&W asserted that the NPR proposal would effectively ban the use of integration clauses. The firm, however, suggested that the Commission could limit the proposed prohibition by applying it only "if an integration clause or other contract provision specifically disclaims representations made in the disclosure document. Alternatively, or perhaps additionally, require a representation by the franchisor at the end of Item 17 that the information contained in the disclosure document is unaffected by any integration clause." PMR&W, Comment 4, at 17.

It is clear that franchisors use integration clauses and waivers in many different contexts, not just for pre-sale disclosure. The impact of these clauses and waivers in the franchise industry, however, is unclear. Nevertheless, based upon the record, the staff recommends that the Commission prohibit the use of integration clauses and waivers in limited circumstances, as follows.

i. Third-party statements

As an initial matter, we note that the NPR did not purport to ban integration clauses or waivers as a deceptive or unfair practice, and we propose no such step now. Indeed, it is the Commission's view that integration clauses and waivers serve valid purposes, including ensuring that a prospective franchisee relies solely on information authorized by the franchisor or within the franchisor's control in making an investment decision. For example, a franchisor reasonably may seek to disclaim responsibility for unauthorized claims made by rogue salespersons, statements made by former or existing franchisees, or even unattributed statements found in the trade press. Therefore, at the very least, integration clauses and waivers are necessary to protect a franchisor from statements or representations made by third parties.

ii. Statements outside the disclosure document

Further, we do not suggest that the proposed anti-disclaimer prohibition reach statements in a franchisor's advertising materials.[833] While there is some merit in the argument that franchisors should not disclaim or waive any authorized statement outside of the disclosure document, our concern is the reliability and integrity of the franchisor's required disclosures. A broader anti-integration and anti-waiver policy is unnecessary to address this concern.

iii. Disclosures other than contractual terms

At the same time, we continue to believe that franchise sellers should not be able to use integration clauses or waivers to insulate themselves from false or deceptive statements made in their disclosure documents. This is particularly true of those sections of the disclosure document pertaining to matters other than the terms of the franchise agreement, such as the franchisor's prior business experience, litigation history, financial performance representations, and financial

---

[833] We also note that a franchisor's advertisements are subject to Commission substantiation and anti-deception requirements, as are all other advertisements under Section 5.

statements. The Commission has long recognized that the integrity of a franchisor's disclosures is critical to prospective franchisees. For that reason, disclosures must be complete, accurate, legible, and current. Further, the Rule also prohibits franchisors from making statements that contradict those in their disclosure documents.[834] The use of integration clauses or waivers[835] to disclaim statements in the disclosure document that the franchisor makes or authorizes would undermine the Rule's very purpose by signaling to prospective franchisees that they cannot trust or rely upon the disclosure document.[836]

Nevertheless, we recognize that an integration clause or waiver would permit a franchisor to narrow its disclosures in unique circumstances. For example, an ice cream store franchisor may make an Item 19 financial performance representation pertaining to units based in Florida. If the franchisor sells units in southern states, the Florida-based representation would be reasonable. However, if the franchisor were to sell a unit in Alaska, the franchisor might wish to use a contract integration clause to ensure that the financial performance representation is inapplicable to the particular sale in Alaska.[837]

In such instances, however, franchisors may be able to protect themselves from liability without reliance on integration clauses or waivers. For example, the ice cream store franchisor noted above, at the very least, could provide the prospective Alaskan franchisee with a disclosure

---

[834] *See* 16 C.F.R. § 436.1(f).

[835] The Commission has also recognized that waivers of rights afforded by Commission trade regulation rules are disfavored. For example, section 455.3(b) of the Used Car Rule, 16 C.F.R. § 455.3(b), requires used car sellers to incorporate the Buyers Guide into their sales contracts. This ensures that used car sellers cannot technically comply with the Rule by affixing the Buyers Guide to a car window, and then turn around and require consumers to waive the very rights granted them under the Rule. Similar anti-waiver provisions can be found in the Credit Practices Rule, 16 C.F.R. § 444.2 (barring certain waivers in credit transactions), Cooling-Off Period Rule, 16 C.F.R § 429.1(d) (barring inclusion in any door-to-door contract of any confession of judgment or "any waiver of any rights to which the buyer is entitled under this section"), and Ophthalmic Practices Rule, 16 C.F.R. § 456.2(d) (barring efforts to have a patient waive or disclaim the liability or responsibility of the ophthalmologist or optometrist for the accuracy of the eye examination).

[836] As noted above in section V, prospective franchisees often rely on the disclosures in making their investment decision, especially when such disclosures appear to have the backing of the Federal Trade Commission. *Cf. FTC v. Minuteman Press,* No. 93-CV-2496 (DRH) (E.D.N.Y. *Memorandum and Order* Oct. 2, 1998) (court holds that a reasonable consumer could "legitimately conclude that he or she was being furnished important specific earnings information . . . notwithstanding . . . general disclaimers in the UFOC").

[837] *See* J&G, Comment 32, at 5.

document that deletes the Item 19 representation. Moreover, the statement of bases and assumptions attached to the disclosure document could make clear that the financial performance representation pertains to Florida or other southern states only. We also note that nothing in the proposed anti-integration clause prohibition would prevent a franchisor from having a prospective franchisee sign an acknowledgment that the Florida-based performance representation does not apply to states such as Alaska. We solicit comment on whether these approaches would protect the franchisor's interests without compromising the integrity of the disclosure document itself.

iv. Contract terms

A more difficult question arises concerning the use of integration clauses or waivers in connection with disclosures pertaining to the franchise agreement itself. Prospective franchisees receive disclosures that summarize contractual terms – such as payments, rights to exclusive territories, and training – as well as a copy of the franchise agreement. It is not unreasonable to assume that, at times, there may be discrepancies or inadvertent conflicts between the two documents. Under the circumstances, franchisors reasonably may assert that the contract itself should be controlling.

Further, if integration or waivers were not permitted, franchisors might simply incorporate language from the contract, which may be in "legalese," into the disclosure document in order to avoid discrepancies. This may have the unintended consequence of making the franchisor's disclosure document less clear.

Accordingly, we must balance these concerns with the prospective franchisees' reasonable expectation that the franchisor's discussion of contractual terms in the disclosure document can be relied upon and trusted. As an initial matter, we recognize that the Commission's ability to bring suit against false or deceptive disclosures, regardless of any contract integration clause or waiver, may encourage complete and accurate disclosure. Nevertheless, we believe that franchisees should not have to rely on Commission action post-sale to resolve conflicting contractual terms. Rather, we believe that a limited proposed integration clause prohibition will encourage franchisors to review their disclosures for accuracy prior to use, thereby avoiding post-sale conflicts and litigation. However, we seek comment on whether we have properly balanced these competing interests.

Further, courts have limited the circumstances where integration clauses matter most – pre-sale fraud. Where there is fraud in the inducement, courts are likely to void the contract, regardless of any integration clause or waiver.[838] For example, in *Alphagraphics Franchising,*

---

[838] *E.g.*, *Cummings v. HPG Int'l, Inc.,* 244 F.3d 16, 21 (1st Cir. 2001) (A party cannot induce a contract by fraudulent misrepresentations and then use contractual devices to escape liability); *Betz Labs. v. Hines,* 647 F.2d 402 (3d Cir. 1989) (Integration clause is part of the contract and if fraud taints the relationship between the parties, the integration clause itself is struck down); *Tibo*

Inc., v. Whaler Graphics, Inc., 840 F. Supp. 708 (D. Ariz. 1993), the court held that there was fraud in the inducement regarding an arbitration forum selection clause, despite the presence of an integration clause in the franchise contract. "It is well-settled that a party cannot free himself from fraud by incorporating [an integration clause] in a contract." (Citations omitted). Accordingly, integration clauses or waivers are not likely to protect franchisors from private suits based upon fraudulent statements made in a disclosure document, even without Commission intervention.

In addition, we believe that franchisors most likely will not import "legalese" into the disclosure document. We note that Item 9 (Franchisee's Obligations) and Item 17 (Renewal, Termination, Transfer, and Dispute Resolution), for example, only require a franchisor to reference, not summarize, the contract. Accordingly, the opportunity for discrepancies is reduced. Other contract provision disclosures require more detail than the contract itself (*e.g.*, the Item 11 discussion of training; the Item 12 discussion of territories, and the Item 16 discussion of sales restrictions). We believe that franchisors can write these disclosures to avoid discrepancies with the contract. Nevertheless, we seek comment on whether plain English requirements have been subverted by the importation into the disclosure document of legalistic contractual provisions that are difficult to understand.

b. Contract negotiations

At the same time, we recognize that prospective franchisees may seek to negotiate terms different from those set forth in the standard contract attached to their disclosure documents. For example, the prospective franchisee may seek a longer term, reduced fees, or modified exclusive territory. Arguably, an integration clause would facilitate negotiations by releasing the parties from restraints imposed by the contractual terms previously disclosed in the disclosure document.

As an initial matter, the staff believes that franchise sellers and prospective franchisees should be free to negotiate the terms of the franchise agreement, as in all other commercial transactions, without fear of violating the Rule. The Commission has no interest in preventing the parties from seeking the best deal possible, as long as the prospective franchisee understands in advance of the sale how the terms and conditions differ from the standard ones set forth in the

---

Software, Inc. v. Gordon Food Serv., Inc., 51 U.C.C. Rep. Serv. 2d, 2003 U.S. Dist. LEXIS 12020 (W.D. Mich. 2003) (An explicit integration clause bars parol evidence with the exception of fraud or other grounds sufficient to set aside a contract); *Jones Distrib. Co. v. White Consol. Indus.,* 943 F. Supp. 1445, 1470-71 (N.D. Iowa 1996) (Fine-print, boiler-plate integration provision is not legally enforceable when there has been fraud that has induced the making of the contract); *Ron Greenspan Volkswagen v. Ford Motor Land Dev. Corp.,* 38 Cal. Rptr. 2d 783, 790 (Ct. App. 1995) (Merger clause will not insulate a seller from liability for misrepresentations, even if the clause specifically disclaims such misrepresentations); *Nobles v. Citizens Mortgage Corp.,* 479 So.2d 822 (Fla. Dist. Ct. App. 1985) (Under Florida law, a merger or integration clause will not bar evidence of fraud in the inducement).

disclosure document, and has the opportunity to review the actual franchise agreement prior to the sale.[839]

The use of an integration or waiver clause, however, is unnecessary to permit contract negotiations. As noted above, the NPR addressed this issue by proposing that a prospective franchisee could negotiate contract terms different from those in the standard contract attached to the disclosure document if: (1) the franchisor identifies the changes; (2) the prospective franchisee initials the changes; and (3) the prospective franchisee has five days to review the revised contract before signing it or paying a fee.[840] Having been fully informed about changes in the franchise agreement before signing, a franchisee would have no grounds to sue post-sale. Nevertheless, commenters voiced concerns about the proposed contract negotiation provision.

The IL AG, for example, observed that the proposed review period for negotiated contracts would begin five days before the prospective franchisee signs the franchise agreement or pays any fee. This would conflict with the proposed general five-day provision, requiring the parties to wait five days before signing the franchise agreement only, but not before paying a fee.[841] Warren Lewis suggested revised language as follows: "if: (1) the franchise seller identifies the changed terms and conditions; (2) the prospective franchisee has 5 days before signing the contract or paying any fee to review the revised contract; and (3) the prospective franchisee initials the changed terms and conditions before or when signing the revised contract." Lewis, Comment 15, at 21. Mr. Lewis also urged the Commission to allow flexibility during the five-day review period, especially if the changes to the contract are requested by the prospective franchisee.

Upon further reflection, we believe that the NPR's approach toward contract negotiations is unnecessary. Many of the concerns about how to permit contract negotiations in lieu of integration clauses or waivers are already addressed in our discussion of the contract review period above.[842] Specifically, in that section we recommend no contract review period where changes are made at the request of the prospective franchisee. Indeed, as noted above, where the

---

[839] Two franchisor representatives specifically urged the Commission to clarify the Rule to ensure that the parties are free to negotiate contract terms. *See* Baer, ANPR 25, at 4-5; Duvall & Mandel, ANPR 114, at 22. They feared that if the franchisor negotiates with a prospective franchisee for different terms than what appears in the disclosure document, (e.g., a different initial franchise fee or royalty payment), the franchisor will effectively violate the Rule because the franchisor will not have furnished the prospective franchisee with a disclosure document spelling out the specific agreed-upon terms and conditions in advance of the sale.

[840] 64 Fed. Reg. at 57,323.

[841] IL AG, Comment 3, at 6. *See also* J&G, Comment 32, Attachment, at 10.

[842] *See* section V.C. above.

prospective franchisee is fully informed about the contractual terms that will govern the relationship before signing the contract, no harm can result and there is no basis for a suit.

Where changes to the contract are initiated by the franchisor, however, we recommend a limited contract review period. At the same time, we also propose a new prohibition, barring franchisors from failing to alert the prospective franchisee to changes between the standard agreement attached to the disclosure document and the agreement to be executed by the parties. We believe these proposals are sufficient to prevent fraud in the negotiation process and preserve the integrity of the franchisor's disclosures. Indeed, in those situations, the prospective franchisee will be able to review the revised contract prior to sale and compare it to the disclosure document.

To avoid any confusion on this issue, we recommend that the Commission make clear in the Rule that the proposed integration clause prohibition does not pertain to contract renegotiations. Accordingly, we recommend that the Commission add the following language to the proposed anti-disclaimer prohibition: "Provided, however, that this provision is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sale negotiations."

3. Proposed section 436.9 (j): Refunds

In the NPR, the Commission also proposed retaining the current prohibition against failing to make refunds.[843] As set forth at 16 C.F.R. § 436.1(h), the current Rule prohibits franchisors and brokers from failing "to return any funds or deposits in accordance with any conditions disclosed pursuant to paragraph (a)(7) of this section." No comments were submitted on this proposal. Nonetheless, we believe that this prohibition should be fine-tuned in one respect. The current refund prohibition is limited to instances where the franchisor or broker makes an express refund promise in the disclosure document itself. It is possible, however, that a franchise seller may not make any specific promise in the disclosure document itself, but may do so either in the franchise agreement, or in a separate contract or letter of understanding. The harm resulting from the failure to honor a promised refund is the same, regardless of where that promise is written. We propose, therefore, that the Commission make clear that the failure to honor any written refund promise will constitute a Rule violation.[844]

---

[843] 64 Fed. Reg. at 57,322.

[844] One commenter, Dady & Garner, suggested that franchisees should always receive a refund (minus actual costs) if they never actually open or operate an outlet. Dady & Garner, ANPR 127, at 4. We believe the substantive terms and conditions of refunds are a matter of contract between the parties, provided the terms and conditions of any refund policy are spelled out in the disclosure document or franchise agreement.

4. Summary of additional prohibition recommendations

Finally, as noted throughout this Report, we have proposed a few narrowly tailored additional prohibitions as alternatives to more detailed disclosures. Although we have addressed the rationale for those new prohibitions in detail above, we will summarize them briefly in this section.

a. Proposed section 436.9(e): Prohibition on failing to furnish disclosures to a prospective franchisee early in the sale process, upon reasonable request

As noted above, we propose that the Commission eliminate the current first personal (face-to-face) meeting disclosure trigger. Nonetheless, we recognize the potential value of early disclosure to a prospective franchisee. To that end, we recommend a new prohibition barring franchisors from failing to furnish a copy of the franchisor's disclosure document to a prospective franchisee, upon reasonable request, earlier in the sales process than is otherwise required by the Rule.[845]

b. Proposed section 436.9(f): Prohibition on failing to furnish existing disclosures to a prospective purchaser of an existing outlet, upon reasonable request

As discussed above, the proposed Rule would retain the Commission's current policy that franchisors furnish disclosures to prospective transferees only if the franchisor is actively involved in the sales process. At the same time, we recognize the potential benefits of pre-sale disclosure to all prospective purchasers. Rather than compelling franchisors to furnish such disclosures, however, we propose a new prohibition barring franchisors from failing to furnish existing disclosures to a prospective purchaser of an existing outlet, upon reasonable request.

c. Proposed section 436.9(g): Prohibition on failing to furnish updated disclosures to a prospective franchisee, upon reasonable request

In our discussion of the proposed updating instructions, we voice concern that a prospective franchisee may rely on stale disclosures by the time he or she is ready to execute the franchise agreement. We stop short, however, of recommending that franchisors be compelled to update their disclosures continuously during the sales process. Rather, any prospective franchisee who is in the sales cycle should have the right to obtain a copy of the franchisor's

---

[845] We also recommend that the Compliance Guides make clear that other franchise sellers can satisfy their obligation to furnish disclosure documents earlier in the sales process by promptly forwarding a prospective franchisee's request to the franchisor, provided that the franchisor has promised to fulfill any such requests promptly.

most recent disclosure document before they agree to execute the franchise agreement. To that end, we recommend that the Commission prohibit franchisors from failing to furnish a copy of the franchisor's most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisees signs a franchise agreement.[846]

d. Proposed section 436.9(h): Prohibition on failing to note contract revisions

In section V.B of this Report, we express concern that a franchisor could commit fraud at the time of executing a franchisee agreement by substituting contract provisions, without notice to the prospective franchisee, that differ materially from those in the original, standard contract attached to the disclosure document. To prevent such abuse, we recommend that the Commission prohibit franchisors from substituting provisions or pages in the agreement without first bringing such changes to the prospective franchisee's attention in a reasonable time before he or she signs the agreement.

XI. PROPOSED SECTIONS 436.10 and 436.11: OTHER LAWS, RULES, ORDERS, AND SEVERABILITY

A. Background

The last sections of the NPR addressed three additional issues:[847] (1) the revised Rule's effect on other Commission laws and rules, and on outstanding Commission orders; (2) preemption of state franchise laws that may be inconsistent with the Rule; and (3) "severability."[848] No comments were submitted on the proposal that the Commission modify outstanding orders that may conflict with the final revised Rule or on the proposed standard severability provision. Accordingly, we recommend that the Commission adopt these proposals, as set forth in the NPR. Comments, however, were submitted on the effect of the Rule on other Commission laws and on preemption. We discuss these two issues below.

---

[846] As with the early disclosure prohibition discussed above, we further recommend that the Compliance Guides make clear that other franchise sellers can satisfy their obligation by promptly forwarding a prospective franchisee's request to the franchisor, provided that the franchisor has promised to fulfill any such requests promptly.

[847] 64 Fed. Reg. at 57,324.

[848] "If any provision of this regulation is stayed or held invalid, the remainder will stay in force." *See* 16 C.F.R. § 436.3.

B. The Record and Recommendations

1. Proposed section 436.10(a): Legality of practices

The current Rule makes clear that the Commission expresses "no opinion as to the legality of any practice mentioned [in a disclosure document]." 16 C.F.R. § 436.3. A disclosure provision should not be construed as condoning or approving of any matter disclosed, or as "an indication of the Commission's intention not to enforce any applicable statute." *Id.* In the SBP, the Commission shed additional light on this issue, explaining that some of the Rule's provisions may require franchisors to disclose practices that may raise legal issues, such as antitrust issues.[849] By requiring disclosure, the Commission was not giving approval to practices that might violate other Commission laws.

In the NPR, the Commission again made clear that it reserves the right to pursue violations of antitrust or other laws even if a franchisor effectively discloses the violation when complying with the Rule's disclosure requirements. In short, pre-sale disclosure does not create a safe harbor for franchisors engaging in otherwise unlawful conduct.[850]

This proposal generated two comments. Howard Bundy focused on the first part, that "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." He would make it a separate prohibition for a franchisor to represent to any person that the Commission has reviewed or approved the form or content of any disclosure document.[851]

The NFC focused on the last sentence, that the "Commission also intends to enforce all applicable statutes and trade regulation rules." In essence, the NFC contended that, under more recent case law, disclosure in some instances may shield a practice that otherwise might be a law violation. According to the NFC, a franchisor's disclosure of certain product or sourcing restrictions, for example, may relieve the franchisor from antitrust "tying" liabilities.[852]

The staff recommends that the Commission retain the proposal on the revised Rule's legal effect, as set forth in the NPR. We agree with Mr. Bundy that no franchisor should represent that the Commission has reviewed or approved any disclosures. Our proposed revised Rule, however, would mandate that a franchisor state expressly on their disclosure document

---

[849] 43 Fed. Reg. at 59,719.

[850] 64 Fed. Reg. at 57,324.

[851] Bundy, Comment 18, at 15.

[852] NFC, Comment 12, at 24.

cover page that the Commission has not reviewed or approved of the disclosures. This should be sufficient to correct any misrepresentation to the contrary. Moreover, such a false statement would already be actionable as a violation of Section 5 of the FTC Act. Under the circumstances, we believe no additional prohibition is needed.

We also find the NFC's concerns to be misplaced. The "legal effect" proposal restates the general policy that disclosure alone does not shield a franchisor from otherwise illegal conduct. To that end, it reserves the Commission's right to enforce other Commission laws that may affect a franchisor's conduct. When enforcing the laws it administers, the Commission, of course, will analyze the facts and the current state of the law to determine whether there is in fact a law violation in the first instance. The proposal does nothing more than state that the Commission will continue to enforce the laws it administers, where there is a legal basis to do so. If a disclosure makes conduct legal, as the NFC asserts, then the Commission obviously would have no reason to believe the franchisor has committed a law violation.

The staff further recommends that the Commission adopt the proposal clarifying that compliance with the Rule's specific disclosure obligations will not shield a franchisor from other violations of Section 5. In short, a franchisor may violate Section 5 by omitting material information even if the franchisor complies fully with the Rule's specific disclosure requirements.[853] The staff believes that this Rule clarification merely restates current Commission law, and is critical in an age of quickly advancing technologies and changes in corporate structures. For example, we cannot now predict what disclosures will be material in the future, in particular franchisors' and franchisees' rights and obligations concerning issues such as Internet home-pages, electronic advertising, and electronic commerce. Nor can we predict large corporate bankruptcies, and even criminal suits against company officials, which have become more common. Therefore, a franchisor's disclosure obligations under Section 5

---

[853] For example, under the current Rule, no disclosure of state or local licensing provisions is required. Nonetheless, in *U.S. v. Lifecall Sys. Inc.*, No. 90-3666 (D.N.J. 1990), the Commission alleged that the defendants violated Section 5 by misrepresenting that purchasers of their emergency alert system franchises would not have to register with state or local authorities. *See also Car Checkers of Am.*, Bus. Franchise Guide (CCH) ¶ 10,163 (alleging that defendants violated Section 5 by failing to disclose state insurance licensing requirements); *Blanc,* Bus. Franchise Guide (CCH) ¶ 10,032 (alleging that defendants violated Section 5 by misrepresenting availability of medical insurance). *Cf. FTC v. Carribean Clear, Inc.,* Bus. Franchise Guide (CCH) ¶ 10,029 (D.S.C. 1992) (permanent injunction included prohibition against future misrepresentations of the effectiveness and safety of defendants' swimming pool water purifier). Similarly, a practice may violate the Rule and Section 5 simultaneously. For example, in numerous Franchise Rule cases the Commission alleges that the defendants violated Section 5 by using shills (phony references), even though that conduct also violates the Rule's mandate to disclose completely and accurately information about existing and former franchisees. *See* 16 C.F.R. § 436.1(a)(16).

must remain flexible to ensure that franchisors continue to provide prospective franchisees with material information as new technologies and marketing practices emerge, and corporations restructure. This does not mean that a franchisor must include other material information in its disclosure document. Indeed, the prohibition against including additional materials, other than non-preempted state law requirements, would bar a franchisor from expanding its disclosures to include even additional material information.[854] Rather, a franchisor might be compelled under Section 5 to disclose information to a prospective franchisee separately from the disclosure document.

2. Proposed section 436.10(c): Preemption

In the NPR, the Commission proposed retaining the preemption provision currently found at footnote 2, with minor editing:[855]

> The FTC does not intend to preempt the franchise practice 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.

In response to the NPR, The IL AG urged the Commission to include the following statement in the Rule regarding preemption: "Compliance with a state franchise regulation that is substantially the same as an FTC requirement shall also satisfy that corresponding FTC regulation." IL AG, Comment 3, at 9. We believe such language is unnecessary in light of the

---

[854] In its comment, H&H seemed to interpret the proposal as requiring franchisors to include other, unspecified, material information in their disclosure documents. H&H asserted that this would be unfair, giving the franchise community no indication what may or may not be deemed material. H&H, Comment 9, at 8. Proposed section 436.10(a) merely reaffirms the current state of the law that franchise sellers may have other obligations under Section 5 of the FTC Act beyond those stated in the Franchise Rule. In that regard, franchise sellers are no different from other businesses subject to Commission trade regulation rules. For example, Section 5 would prohibit a used car salesman from misrepresenting a rebate program or from misrepresenting whether a used car had previous damage, even though the salesman may otherwise comply with the Used Car Rule's warranty disclosures.

[855] 64 Fed. Reg. at 57,324. *See also* 16 C.F.R. Part 436, note 2. Elevating the preemption discussion from a footnote to a Rule section is consistent with other Commission trade regulations rules. *See, e.g.,* Appliance Labeling Rule, 16 C.F.R. Part § 305.17; Cooling-Off Rule, 16 C.F.R. § 429.2; Mail Order Rule, 16 C.F.R. § 435.3(b)(2); R-Value Rule, 16 C.F.R. § 460.23.

Rule's preemption provision that basically says the same thing. Moreover, it could confuse the issue by adding a new, undefined, standard – "substantially the same."

Several franchisors urged the Commission to preempt the field of pre-sale disclosure in order to ensure that there is one, national, disclosure standard.[856] PMR&W, for example, voiced concern that some of the "forward-thinking" aspects of the NPR – such as the phase-in of audited financial statements and revised cover page – could be rendered ineffective by contrary state policies. The firm did not challenge states' right to comment on a franchisor's failure to comply with a required disclosure standard during the registration and review process. However, the underlying disclosure standard should be uniform.[857] Similarly, Snap-On maintained that:

> the myriad of state regulations that apply to franchise disclosure add a great deal of extra effort to the Offering Circular process and serve no real purpose beyond what has already been served by compliance with the Federal Trade Commission Rule on Franchising. As such, complete preemption of state law in this area, which would make the franchise regulations truly uniform, is sought.

Snap-On, Comment 16, at 1.[858]

We reject the call to expand the preemptive effect of the Rule. As a preliminary matter, it is clear that the proposed revised Rule, if adopted, would create a new disclosure floor with which all franchisors must comply. It is our hope that NASAA and the states would adopt the revised Rule, further reducing inconsistencies between federal and state law. However, the Commission lacks the legal basis to preempt the field of pre-sale disclosure law.

The preemptive effect of any federal law is fundamentally a question of Congressional intent. Unless Congress has expressly provided for preemption by occupying the field, then preemption can exist only where there is a conflict between federal and state law that creates an "obstacle to the accomplishment and execution of the full purposes and objectives of

---

[856] *But see* IL AG Rebuttal, Comment 38, at 1-2 ("federalism has served the public well").

[857] PMR&W, Comment 4, at 7-8.

[858] *See also* Baer, Comment 11, at 2; GPM Rebuttal, Comment 40, at 8. A few commenters told us that additional guidance is needed in understanding the interrelationship between the Rule and the UFOC Guidelines. For example, PMR&W urged the Commission to clarify conflicting updating requirements and how broader UFOC provisions might apply in non-registration states. *E.g.,* PMR&W, Comment 4, at 7. We acknowledge this concern. Currently, the Commission addresses such issues in the Interpretive Guides. We believe this is the best approach for addressing explanations of Commission policy. Accordingly, we recommend that the Commission address the interrelationship between federal and state disclosure issues in the Compliance Guides that will accompany the revised Rule.

Congress."[859] Indeed, the Supreme Court has been reluctant to find preemption of state laws, holding that there is a presumption against preemption,[860] unless that is the "clear and manifest purpose of Congress."[861]

The Federal Trade Commission Act does not include any clause directly preempting state law. Furthermore, the legislative history of the Act and of the 1975 amendments to the Act establishing the Commission's rulemaking authority indicate that Congress did not intend the Act to occupy the field of consumer protection regulation.[862] Any preemptive effect of the Franchise Rule, therefore, is limited to instances where state law conflicts with the FTC requirements, such that a "repugnancy" is created between the state laws and the Commission regulations.[863] Preemption would occur where there is an "actual conflict between the two schemes of regulation [such] that both cannot stand in the same area."[864] Accordingly, the Commission generally has declared the preemptive effect of Commission rules to be limited to the extent of an inconsistency only[865] and in some instances (such as with the UFOC Guidelines) has provided a mechanism by which a state or local government may petition the Commission to permit enforcement of any part of a state or local law that would provide for greater consumer protections than an FTC rule's requirements.[866] Therefore, absent federal legislation evidencing a clear intent from Congress to occupy the field of pre-sale franchise disclosure, the revised Franchise Rule would not affect state laws providing greater consumer protection.

---

[859] *Gade v. Nat'l Sold Wastes Mgmt. Ass'n,* 505 U.S. 88, 98-99 (1992); *Fla. Lime & Avocado Growers, Inc., v. Paul,* 373 U.S. 132, 141 (1963); *Hines v. Davidowitz,* 312 U.S. 52, 67 (1941). These standards apply to federal regulations, as well as federal statutes. *E.g.*, *Fid. Fed. Sav. & Loan Ass'n v. de la Cuesta,* 458 U.S. 141, 153 (1982).

[860] *Rice v. Santa Fe Elevator Corp.,* 331 U.S. 218, 230 (1947).

[861] *Cipollone v. Liggett Group, Inc.,* 505 U.S. 504, 516 (1992).

[862] *E.g., Am. Fin. Servs. Ass'n v. FTC,* 767 F.2d 957, 989 (1985). *See also* Paul R. Verkuil, Preemption of State Law by the Federal Trade Commission, 1976 *Duke Law Journal* 225.

[863] *E.g., Am. Fin. Servs.,* 767 F.2d 957 (Credit Practices Rule); *Harry and Bryant Co. v. FTC,* 726 F.2d 993 (4th Cir. 1984) (Funeral Rule); *Am. Optometric Assoc. v. FTC,* 626 F.2d 896 (D.C. Cir. 1980) (Opthalmic Practices Rule).

[864] *Fla. Lime & Avocado Growers,* 373 U.S. at 141.

[865] *E.g.,* Mail or Telephone Order Merchandise Rule, 16 C.F.R. § 435.3; R-Value Rule, 16 C.F.R. § 460.23.

[866] *E.g.,* Funeral Rule, 16 C.F.R. § 453.9; Credit Practices Rule, 16 C.F.R. § 444.5; and Used Car Rule, 16 C.F.R. § 455.6.

We further note that preemption of state franchise disclosure laws would be inconsistent with the current policy on federalism, as announced in Executive Order 13132 on August 4, 1999.[867] Among other things, the Executive Order provides that federal agencies should carefully assess the necessity of limiting the policymaking discretion of the states and such actions should be taken "only where there is constitutional and statutory authority for the action and the national activity is appropriate in light of the presence of a problem of national significance." It also encourages agencies, in appropriate circumstances, to defer to the states to establish standards. As noted above, there is no statutory basis for preempting the states in the franchise pre-sale disclosure arena, nor do we find any compelling reason to limit the states' discretion in this field. Rather, by adopting the UFOC Guidelines, which the commenters agree is superior to the current Franchise Rule, the states have taken a leadership role in this field. For that reason, we recommend, and many of the commenters support, using the UFOC Guidelines model when revising the Rule. Under the circumstances, we must reject any suggestion that the Commission expand the Franchise Rule's preemptive effect. There simply is no legal or policy basis for such an expansion.

XII. CONCLUSION

The rule amendment record demonstrates the need to update the Franchise Rule to address new technologies and to provide prospective franchisees with more disclosure about the nature of the franchise relationship, while minimizing discrepancies between federal and state law. This report analyzes the entire record and sets forth the staff's recommendations as to the form of the final revised Rule. We recognize that reasonable people may differ with our recommendations. We, therefore, welcome comment on this report and the proposed final revised Rule provisions during the next 60 days, as provided by the Commission's Rules of Practice, 16 C.F.R. § 1.13(h).

[867] Although the Executive Order is not binding on independent agencies, such as the Federal Trade Commission, it nonetheless sets forth principles that the Commission might consider in determining the preemptive effect of its regulations.

ATTACHMENT A

TABLE OF COMMENTERS

Notice of Proposed Rulemaking

Comment 1. Patrick E. Meyers, The Quizno's Corporation ("Quizno's)
Comment 2. Steven A. Rosen, Frannet ("Frannet")
Comment 3. Robert Tingler, Franchise Bureau Chief, Illinois Attorney General ("IL AG")
Comment 4. Dennis E. Wieczorek, Piper Marbury Rudnick & Wolfe ("PMR&W")
Comment 5. Jack Schuessler, Wendy's Intl, Inc. ("Wendy's")
Comment 6. Curtis S. Gimson, Triarc Restaurant Group ("Triarc")
Comment 7. Eugene Stachowiak, McDonald's ("McDonalds")
Comment 8. David E. Holmes ("Holmes")
Comment 9. Erik B. Wulff, John F. Dienelt, Hogan & Hartson ("H&H")
Comment 10. Ronnie R. Volkening, 7-Eleven, Inc. ("7-Eleven")
Comment 11. John R.F. Baer, Robert T. Joseph, Alan H. Silberman, Sonnenschein Nath & Rosenthal ("Baer")
Comment 12. Morton A. Aronson, Neil A. Simon, David J. Kaufmann, National Franchise Council ("NFC")
Comment 13. Alaska Turner ("Turner")
Comment 14. Susan P. Kezios, American Franchisee Association ("AFA")
Comment 15. Warren L. Lewis, Lewis & Kolton ("Lewis")
Comment 16. John W. Regnery, Snap-On Inc. ("Snap-On")
Comment 17. Dale E. Cantone, Stephen W. Maxey, Joseph J. Punturo, NASAA Franchise and Business Opportunity Project Group ("NASAA")
Comment 18. Howard E. Bundy, Bundy & Morrill, Inc. ("Bundy")
Comment 19. Laurie Taylor ("Taylor")
Comment 20. Jonathan Hubbell, Prudential Real Estate Affiliates ("PREA")
Comment 21. David Gurnick, Arter & Hadden ("Gurnick")
Comment 22. Don J. DeBolt, Matthew R. Shay, International Franchise Association ("IFA")
Comment 23. L. Seth Stadfeld, Weston, Patrick, Willard & Redding ("Stadfeld")
Comment 24. Eric H. Karp, Witmer, Karp, Warner & Thuotte ("Karp")
Comment 25. Janet L. McDavid, American Bar Association, Section of Antitrust Law ("ABA AT")
Comment 26. Randall Loeb, NaturaLawn of America ("NaturaLawn")
Comment 27. Tony Rolland, National Franchisee Association ("NFA")
Comment 28. Andrew P. Loewinger, Buchannan Ingersoll ("BI")
Comment 29. Jeffrey E. Kolton, Frandata ("Frandata")
Comment 30. AFC Enterprises ("AFC")
Comment 31. Howard Morrill, Bundy & Morrill, Inc. ("Morrill")
Comment 32. Carl E. Zwisler, Jenkens & Gilchrist ("J&G")
Comment 33. Diane T. Nauer, TruServ Corporation ("TruServ")

Comment 34. Brian H. Cole, Tricon ("Tricon")
Comment 35. Steven Goldman, Mark Forseth, Marriott Corp. ("Marriott")
Rebuttal Comment 36. Gurnick (*see supra* Comment 21).
Rebuttal Comment 37. Kezios (*see supra* Comment 14).
Rebuttal Comment 38. IL AG (*see supra* Comment 3)
Rebuttal Comment 39. Bundy (*see supra* Comment 18)
Rebuttal Comment 40. John W. Fitzgerald, Gray, Plant, Mooty, Mooty & Bennett ("GPM")

Advance Notice of Proposed Rulemaking

Commenters

ANPR Comment 1. Kevin Brendan Murphy, Mr. Franchise ("Murphy")
ANPR Comment 2. Murphy (*see supra,* Comment 1).
ANPR Comment 3. Mike Bruce, The Michael Bruce Fund ("Bruce")
ANPR Comment 4. Harold Brown, Brown & Stadfeld ("Brown")
ANPR Comment 5. Frances L. Diaz ("Diaz")
ANPR Comment 6. Brown (*see supra,* Comment 4).
ANPR Comment 7. Diaz (*see supra,* Comment 5).
ANPR Comment 8. Marian Kunihisa ("Kunihisa")
ANPR Comment 9. Kevin Bores, Domino's Pizza Franchisee ("Bores")
ANPR Comment 10. Terrence L. Packer, Supercuts Franchisee ("Packer")
ANPR Comment 11. John Delasandro ("Delasandro")
ANPR Comment 12. William Cory ("Cory")
ANPR Comment 13. Joseph Manuszak, Domino's Franchisee ("Manuszak")
ANPR Comment 14. Daryl Donafin, Taco Bell Franchisee ("Donafin")
ANPR Comment 15. David Muncie, National Claims Service, Inc. ("Muncie")
ANPR Comment 16. Patrick E. Meyers, The Quizno's Corp. ("Quizno's")
ANPR Comment 17. David Weaver, Domino's Pizza Franchisee ("Weaver")
ANPR Comment 18. Karen M. Paquet, Domino's Pizza Franchisee ("Paquet")
ANPR Comment 19. Gary R. Duvall Graham & Dunn ("Duvall")
ANPR Comment 20. Andrew J. Sherman, Greenberg & Tauris ("Sherman"),
ANPR Comment 21. S. Beavis Stubbings ("Stubbings")
ANPR Comment 22. Jim & Evalena Gray, Pearle Vision Franchisee ("J&E Gray")
ANPR Comment 23. Ernest Higginbotham ("Higginbotham")
ANPR Comment 24. Henry C. Su & Bryon Fox ("Su")
ANPR Comment 25. John R. F. Baer, Keck, Mahin & Cate ("Baer"),
ANPR Comment 26. Clay Small & Lowell Dixon, Nat'l Franchise Mediation Program Steering Committee ("NFMP")
ANPR Comment 27. Richard T. Catalano ("Catalano")
ANPR Comment 28. Neil Simon & Erik Wulff, Hogan & Hartson ("H&H")
ANPR Comment 29. Glenn A. Mueller, Domino's Pizza Franchisee ("Mueller")
ANPR Comment 30. Doug Bell et al. Supercuts Franchisees ("Supercut Franchisees")

ANPR Comment 31. Michael L. Bennett, Longaberger Co. ("Longaberger")
ANPR Comment 32. John Rachide, Domino's Pizza Franchisee ("Rachide")
ANPR Comment 33. David J. Kaufmann, Kaufmann, Feiner, Yamin, Gildin & Robbins ("Kaufmann")
ANPR Comment 34. Joseph N. Mariano, Direct Selling Association ("DSA")
ANPR Comment 35. Linda F. Golodner & Susan Grant, National Consumers League ("NCL")
ANPR Comment 36. Jere W. Glover & Jennifer A. Smith, U.S. Small Business Administration Office of Chief Counsel for Advocacy ("SBA Advocacy")
ANPR Comment 37. Robert Chabot, Domino's Pizza Franchisee ("Chabot")
ANPR Comment 38. Teresa Maloney, National Coalition of 7-Eleven Franchisees ("Maloney")
ANPR Comment 39. BLANK
ANPR Comment 40. Harold L. Kestenbaum ("Kestenbaum")
ANPR Comment 41. Samuel L. Sibent, KFC Franchisee ("Sibent")
ANPR Comment 42. Oren C. Crothers, KFC Franchisee ("Crothers")
ANPR Comment 43. Matthew Jankowski, KFC Franchisee ("Jankowski")
ANPR Comment 44. Rodney A. DeBoer, KFC Franchisee ("DeBoer")
ANPR Comment 45. Liesje Bertoldi, KFC Franchisee ("L. Bertoldi)"
ANPR Comment 46. Steve Bertoldi, KFC Franchisee ("S. Bertoldi")
ANPR Comment 47. Charles Buckner, KFC Franchisee ("Buckner")
ANPR Comment 48. Walter J. Knezevich, KFC Franchisee ("Knezevich")
ANPR Comment 49. Jeffrey W. Gray, KFC Franchisee ("J. Gray")
ANPR Comment 50. Fred Jackson, KFC Franchisee ("Jackson")
ANPR Comment 51. Ronald L. Rufener, KFC Franchisee ("Rufener"
ANPR Comment 52. Tim Morris, KFC Franchisee ("Morris)"
ANPR Comment 53. Scarlett Norris Adams, KFC Franchisee ("Adams")
ANPR Comment 54. Calvin G. White, KFC Franchisee ("White")
ANPR Comment 55. Nick Iuliano, KFC Franchisee ("N. Iuliano")
ANPR Comment 56. Dolores Iuliano, KFC Franchisee ("D. Iuliano")
ANPR Comment 57. Ralph A Harman, KFC Franchisee ("R. Harman")
ANPR Comment 58. Saundra S. Harman, KFC Franchisee ("S. Harman"
ANPR Comment 59. Richard Braden, KFC Franchisee ("Barden")
ANPR Comment 60. K.F. C. of Pollys, KFC Franchisee ("Pollys")
ANPR Comment 61. Joan Fiore, McDonalds Franchisee ("Fiore")
ANPR Comment 62. Susan P. Kezios, American Franchisee Association ("AFA")
ANPR Comment 63. Kenneth R. Costello, Loeb & Loeb ("Costello")
ANPR Comment 64. AFA (ANPR *see supra,* Comment 62)
ANPR Comment 65. Susan Rich, KFC Franchisee ("Rich")
ANPR Comment 66. Fiore (*see supra* Comment 61)
ANPR Comment 67. Mike Johnson, Subway Franchisee ("Johnson")
ANPR Comment 68. Laurie Gaither, GNC Franchisee ("L. Gaither")
ANPR Comment 69. Greg Gaither, GNC Franchisee ("G. Gaither")
ANPR Comment 70. Greg Suslovic, Subway Franchisee ("Suslovic")
ANPR Comment 71. Richard Colenda, GNC Franchisee ("Colenda")

ANPR Comment 72. Bob Gagliati, GNC Franchisee ("Gagliati")
ANPR Comment 73. Pat Orzano, 7-Eleven Franchisee ("Orzano")
ANPR Comment 74. Linda Gaither, GNC Franchisee ("Li Gaither")
ANPR Comment 75. Kevin 100 ("Kevin 100")
ANPR Comment 76. Robert James, Florida Department of Agriculture & Consumer Services ("James")
ANPR Comment 77. Robert A. Tingler, Office of the Attorney General, State of Illinois ("IL AG")
ANPR Comment 78. John M. Tifford, Rudnick, Wolfe, Epstien & Zeidman ("Tifford")
ANPR Comment 79. Robert L. Purvin, Jr. ("Purvin")
ANPR Comment 80. Teresa Heron, My Favorite Muffin Franchisee ("Heron")
ANPR Comment 81. Purvin (*see supra* Comment 79)
ANPR Comment 82. Matthew R. Shay, International Franchise Association ("IFA")
ANPR Comment 83. Duvall (*see supra* Comment 19)
ANPR Comment 84. Lance Winslow, Car Wash Guys ("Winslow")
ANPR Comment 85. Winslow (*see supra* Comment 84)
ANPR Comment 86. Rick Gue, The Pampered Chef, ("Pampered Chef")
ANPR Comment 87. John M. Tifford, Coverall North America ("Coverall")
ANPR Comment 88. John M. Tifford, Merchandise Mart Properties ("Merchanise Mart")
ANPR Comment 89. Dirk C. Bloemendaal, Amway Corproation ("Amway")
ANPR Comment 90. Winslow (*see supra* Comment 84)
ANPR Comment 91. Winslow (*see supra* Comment 84)
ANPR Comment 92. Winslow (*see supra* Comment 84)
ANPR Comment 93. Winslow (*see supra* Comment 84)
ANPR Comment 94. Andrew A. Caffey ("Caffey")
ANPR Comment 95. Entrepreneur Media, Inc. ("Entrepreneur")
ANPR Comment 96. Brown (*see supra* Comment 4)
ANPR Comment 97. Raymond & Robert Buckley, Scorecard Plus Franchisees ("Buckley")
ANPR Comment 98. Mark A. Kirsch, Rudnick, Wolfe, Epstien & Zeidman ("Kirsch")
ANPR Comment 99. Dale E. Cantone, Maryland Division of Securities, Office of the Attorney General ("Md Securities")
ANPR Comment 100. Roger C. Haines, Scorecard Plus Franchisee ("Haines")
ANPR Comment 101. David E. Myklebust, Scorecard Plus Franchisee ("Myklebust")
ANPR Comment 102. Robert Larson ("Larson")
ANPR Comment 103. Brown (*see supra* Comment 4)
ANPR Comment 104. Mark B. Forseth, CII Enterprises ("CII")
ANPR Comment 105. Bertrand T. Unger, PR One ("Pr One")
ANPR Comment 106. Dennis E. Wieczorek, Rudnick & Wolfe ("Wieczorek")
ANPR Comment 107. Gerald A. Marks, Marks & Krantz ("Marks")
ANPR Comment 108. Brown (*see supra* Comment 4)
ANPR Comment 109. Everett W. Knell ("Knell")
ANPR Comment 110. Anne Crews, Mary Kay, Inc. ("Mary Kay")
ANPR Comment 111. Carl Letts, Domino's Pizza Franchisee ("Letts")

ANPR Comment 112. Kat Tidd ("Tidd")
ANPR Comment 113. Ted Poggi, National Coalition of Associations of 7-Eleven Franchisees ("NCA 7-Eleven Franchisees)
ANPR Comment 114. Gary R. Duvall & Nadine C. Mandel ("Duvall & Mandel")
ANPR Comment 115. Sherry Christopher, Christopher Consulting, Inc. ("Christopher")
ANPR Comment 116. Carl C. Jeffers, Intel Marketing Systems, Inc. ("Jeffers")
ANPR Comment 117. Deborah Bortner, State of Washington, Department of Financial Institutions, Securities Divisions ("WA Securities")
ANPR Comment 118. Carmen D. Caruso, Noonan & Caruso ("Caruso")
ANPR Comment 119. Howard Bundy, Bundy & Morrill, Inc.("Bundy")
ANPR Comment 120. Franchise & Business Opportunity Committee, North American Securities Administrations Association ("NASAA")
ANPR Comment 121. Tifford (*see supra* Comment 78)
ANPR Comment 122. Wieczorek (*see supra* Comment 106)
ANPR Comment 123. John & Debbie Lopez, Baskin & Robbins Franchisee ("Lopez")
ANPR Comment 124. Susan R. Essex & Ted Storey, California Bar, Business Law Section ("CA BLS")
ANPR Comment 125. Peter C. Lagarias, The Legal Solutions Group ("Lagarias")
ANPR Comment 126. James G. Merret, Jr. ("Merret")
ANPR Comment 127. W. Michael Garner, Dady & Garner ("Garner")
ANPR Comment 128. Jeff Brickner ("Brickner"
ANPR Comment 129. Bernard A. Brynda, Baskin & Robbins Franchisee ("Brynda")
ANPR Comment 130. Caron B. Slimak, Jacadi USA Franchisee ("Slimak")
ANPR Comment 131. Dr. Ralph Geiderman, Pearl Vision Franchisee ("Geiderman")
ANPR Comment 132. Felipe Frydmann, Minister of Economic & Trade Affairs, Embassy of the Argentine Republic ("Argentine Embassy")
ANPR Comment 133. Andrew C. Selden, Briggs & Morgan ("Selden")
ANPR Comment 134. Robert Zarco, Zarco & Pardo ("Zarco & Pardo")
ANPR Comment 135. Jason H. Griffing, Baskin & Robbins Franchisee ("Griffing")
ANPR Comment 136. Erik H. Karp, Witmer, Karp, Warner & Thuotte ("Karp")
ANPR Comment 137. William D. Brandt, Ferder, Brandt, Casebeer, Copper, Hoyt & French ("Brandt")
ANPR Comment 138. Robert S. Keating, Baskin & Robbins Franchisee ("Keating")
ANPR Comment 139. A. Patel, Baskin & Robbins Franchisee ("A. Patel")
ANPR Comment 140. Joel R. Buckberg, Cendant Corporation ("Cendant")
ANPR Comment 141. Duvall (*see supra* Comment 19)
ANPR Comment 142. NCL (*see supra* Comment 35)
ANPR Comment 143. AFA (*see supra* Comment 62)
ANPR Comment 144. Catalano (*see supra* Comment 27)
ANPR Comment 145. DSA (*see supra* Comment 34)
ANPR Comment 146. Keating (*see supra* Comment 139)
ANPR Comment 147. Kathie & David Leap, Baskin & Robbins Franchisee ("Leap")
ANPR Comment 148. Ted D. Kuhn, Baskin & Robbins Franchisee ("Kuhn")

ANPR Comment 149. Mike S. Lee, Baskin & Robbins Franchisee ("Lee")
ANPR Comment 150. R. Deilal, Baskin & Robbins Franchisee ("Deilal")
ANPR Comment 151. Frank J. Demotto, Baskin & Robbins Franchisee ("Demotto")
ANPR Comment 152. Thomas Hung, Baskin & Robbins Franchisee ("Hung")
ANPR Comment 153. Jean Jones, Baskin & Robbins Franchisee ("Jones")
ANPR Comment 154. Hang, Baskin & Robbins Franchisee ("Hang")
ANPR Comment 155. Dilip Patel, Baskin & Robbins Franchisee ("D. Patel")
ANPR Comment 156. Terry L. Glase, Baskin & Robbins Franchisee ("Glase")
ANPR Comment 157. R.E. Williamson, Baskin & Robbins Franchisee ("Williamson")
ANPR Comment 158. R. M Valum, Baskin & Robbins Franchisee ("Valum")
ANPR Comment 159. Rajendra Patel, Baskin & Robbins Franchisee ("R. Patel")
ANPR Comment 160. Jerry & Debbie Robinett, Baskin & Robbins Franchisee ("Robinett)
ANPR Comment 161. Ronald J. Rudolf, Baskin & Robbins Franchisee ("Rudolf")
ANPR Comment 162. Kamlesh Patel, Baskin & Robbins Franchisee ("K. Patel")
ANPR Comment 163. Nicholas & Marilyn Apostal, Baskin & Robbins Franchisee ("Apostal")
ANPR Comment 164. Patrick Sitin, Baskin & Robbins Franchisee ("Sitin")
ANPR Comment 165. Paul & Lisa SeLander, Baskin & Robbins Franchisee ("SeLander")
ANPR Comment 166. S. Bhilnym, Baskin & Robbins Franchisee ("Bhilnym")
ANPR Comment 167. Mike & Kathy Denino, Baskin & Robbins Franchisee ("Denino")

Workshop Participants

Michael Bennett, Longaberger Company ("Bennett")
Kennedy Brooks ("Brooks")
John Brown, Amway Corporation ("J. Brown")
Howard Bundy, Bundy & Morrill ("Bundy")
Delia Burke, Jenkins & Gilchrist ("Burke")
Andrew Caffey, Esq. ("Caffey")
Dale Catone, Office of the Maryland Attorney General ("Cantone")
Emilio Casillas, Washington State Securities Division ("Casillas")
Richard Catalano, Esq. ("Catalano")
Sherry Christopher, Esq. ("Christopher")
Michael W. Chiodo, Domino's Franchisee ("Chiodo")
Martin Cordell, Washington State Securities Division ("Cordell")
Joseph Cristiano, Carvel Franchisee ("Cristiano")
John D'Alessandro, Quaker State Lube Distributor ("D'Alessandro")
Mark Deutsch, former franchisee ("Deutsch")
Steve Doe, Franchisee ("Doe")
Gary Duvall, Graham & Dunn ("Duvall")
Eric Ellman, Direct Selling Association ("Ellman")
Debbie Fetzer, Snap-On Franchisee ("Fetzer")
David Finigan, Illinois Securities Department ("Finigan")
Mark B. Forseth, Jenkens & Gilchrist ("Forseth")

Richard W. Galloway, Domino's Pizza Franchisee ("Galloway")
Elizabeth Garceau, Pro Design ("E. Garceau")
Michael Garceau, Pro Design ("M. Garceau")
Roger Gerdes, Microsoft Corp. ("Gerdes")
Rick Geu, The Pampered Chef ("Geu")
Judy Gitterman, Jenkens & Gilchrist ("Gitterman")
Susan Grant, National Consumers League ("Grant")
Bruce Hoar, Hanes Franchisee ("B. Hoar")
Thomas Hoar, Hanes Franchisee ("T. Hoar")
Nelson Hockert-Lotz, Domino's Pizza Franchisee ("Hockert-Lotz")
Tee Houston-Aldridge, World Inspection Network ("Houston-Aldridge")
Robert James, Florida Dept. of Agriculture & Consumer Services ("James")
Carl Jeffers, Intel Marketing Systems ("Jeffers")
Erik Karp, Witmer, Karp, Warner & Thuotte ("Karp")
David Kaufmann, Kaufmann, Feiner, Yamin, Gildin & Robbins ("Kaufmann")
Harold Kestenbaum, Hollenbrug, Bleven, Solomon, Ross ("Kestenbaum")
Susan Kezios, American Franchisee Association ("Kezios")
Mark Kirsch, Rudnick Wolfe, Epstien & Zeidman ("Kirsch")
Charles Lay, Brite Site Franchisee ("Lay")
Mike Ludlum, Entreprenuer Media ("Ludlum")
Marge Lundquist, Franchisee ("Lundquist")
Gerald Marks, Marks & Krantz ("Marks")
Philip McKee, National Consumers League ("McKee")
Dianne Mousley, Mike Schmidt's Phil. Hoagies Franchisee ("Mousley")
Joseph Punturo, Office of the New York Attorney General ("Punturo")
Mehran Rafizadeh, GNC Franchisee ("Rafizadeh")
David R. Raymond, Esq. ("Raymond")
Iris Sandow, Blimpie Franchisee ("Sandow")
Philip Sanson, Illinois Securities Department ("Sanson")
Matthew Shay, International Franchise Association ("IFA")
David Silverman, Sportworld Int'l ("Silverman")
Neil Simon, Hogan & Hartson ("Simon")
Caron Slimak ("Slimak"), Jacadi USA Franchisee
J. H. Snow, Jenkens & Gilcrist ("Snow")
Adam Sokol, Illinois Attorney General's Office ("Sokol")
Kat Tidd, Esq. ("Tidd")
John Tifford, Rudnick Wolfe, Epstien & Zeidman, ("Tifford")
Robert Tingler, Franchise Bureau Chief. Illinois Attorney General's Office ("Tingler")
Bertrand Unger, PR One ("Unger")
Dr. Spencer Vidulich, Pearle Vision Franchisee ("Vidulich")
Dick Way, PR One ("Way")
Dennis Wieczorek, Rudnick & Wolfe ("Wieczorek")

Erik Wulff, Hogan & Hartson ("Wulff")
Barry Zaslav, Coverall North America ("Zaslav")

Rule Review ("RR")

RR Comment 1. Robert E. Mulloy, Jr. ("Mulloy")
RR Comment 2. Stanley M. Dub, Dworken & Bernstein ("Dub")
RR Comment 3. Marvin J. Migdol, Nationwide Franchise Marketing Services ("Migdol"
RR Comment 4. SCPromotions, Inc. ("SCPromotions")
RR Comment 5. R. Dana Pennell ("Pennell")
RR Comment 6. Robin Day Glenn ("Glenn")
RR Comment 7. Jack McBirney, McGrow Consulting ("McBirney")
RR Comment 8. SRA International ("SRA International")
RR Comment 9. Harld Brown, Brown & Stadfeld ("Brown")
RR Comment 10. Ronald N. Rosenwasser ("Rosenwasser")
RR Comment 11. Louis F. Sokol ("Sokol")
RR Comment 12. J. Howard Beales III, Professor, George Washington University ("Beales")
RR Comment 13. Peter Lagarias ("Lagarias")
RR Comment 14. Harold L. Kestenbaum ("Kestenbaum")
RR Comment 15. Walter D. Wilson, Better Business Bureau of Central Georgia, Inc. ("Wilson")
RR Comment 16. Connie B. D'Imperio, Color Your Carpet, Inc. ("D'Imperio")
RR Comment 17. Q.M. Marketing, Inc ("Q.M. Marketing")
RR Comment 18. David Gurnick, Kindel & Anderson ("Gurnick")
RR Comment 19. U-Save Auto Rental ("U-Save Auto Rental")
RR Comment 20. The Longaberger Co. ("Longaberger")
RR Comment 21. Direct Selling Association ("DSA")
RR Comment 22. American Bar Association, Section on Antitrust Law ("ABA AT")
RR Comment 23. Dennis E. Wieczorek, Rudnick & Wolfe ("Wieczorek")
RR Comment 24. Real Estate National Nework ("RENN")
RR Comment 25. Attorney General Jim Ryan ("General Ryan"), State of Illinois
RR Comment 26. Alan S. Nopar ("Nopar")
RR Comment 27. Snap-On, Inc. ("Snap-On")
RR Comment 28. Steven Rabenberg, Explore St. Louis ("Rabenberg")
RR Comment 29. Douglas M. Brooks, Martland & Brooks ("Brooks")
RR Comment 30. Rober N. McDonald ("Commissioner McDonald"), Securities Commissioner, State of Maryland
RR Comment 31. Little Ceasars ("Little Ceasars")
RR Comment 32. International Franchise Association ("IFA")
RR Comment 33. Brownstein, Zeidman & Lore ("Brownstein Zeidman")
RR Comment 34. Jere W. Glover ("Glover"), Counsel for Advocacy, U.S. Small Business Administration ("SBA Advocacy")
RR Comment 35. Jan Meyers, Chair, House Committee on Small Business ("Representative Myers")

RR Comment 36. Neil A. Simon, Hogan and Hartson ("Simon")
RR Comment 37. Deborah Bortner ("Bortner"), Washington State Department of Financial Institutions, Securities Division
RR Comment 38. American Franchisee Association ("AFA")
RR Comment 39. American Association of Franchisees & Dealers ("AAFD")
RR Comment 40. Warrren Lewis, Lewis & Trattner ("Lewis")
RR Comment 41. Century 21 Real Estate Corp. ("Century 21")
RR Comment 42. John Hayden ("Hayden")
RR Comment 43. North American Securities Administrators Association ("NASAA")
RR Comment 44. Robert L. Perrry ("Perry")
RR Comment 45. The State Bar of California, Business Law Section ("CA BLS")
RR Comment 46. Mike Gaston, Barkely & Evergreen ("Gaston")
RR Comment 47. The Southland Corp. ("Southland")
RR Comment 48. Medicap Pharmacies, Inc. ("Medicap")
RR Comment 49. Rochelle B. Spandorf ("Spandorf"), ABA Forum on Franchising, Andrew C. Selden ("Selden"), David J. Kaufman ("Kaufmann")
RR Comment 50. Joyce G. Mazero, Locke Pernell Rain Harrell ("Mazero")
RR Comment 51. Mark B. Forseth, Locke Pernell Rain Harrell ("Forseth")
RR Comment 52. Forte Hotels ("Forte Hotels")
RR Comment 53. R.A. Politte ("Politte")
RR Comment 54. Politte (*see supra,* Comment 53).
RR Comment 55. Brown (*see supra,* Comment 9).
RR Comment 56. Wieczorek (*see supra,* Comment 23).
RR Comment 57. Scott Shane, Georgia Institute of Technology ("Shane")
RR Comment 58. Friday's ("Friday's")
RR Comment 59. Carl E. Zwisler, Keck, Mahin & Cate ("Zwisler")
RR Comment 60. Wieczorek (*see supra,* Comment 23)
RR Comment 61. Enrique A. Gonzalez, Gonzalez Cavillo Y Forastierei ("Gonzalez")
RR Comment 62. Pepsico Restaurants ("Pepsico")
RR Comment 63. IFA (*see supra,* Comment 32)
RR Comment 64. Atlantic Richfield Co ("ARCO")
RR Comment 65. David Clanton ("Clanton")
RR Comment 66. Leonard Swartz, Arthur Andersen & Co. ("Swartz")
RR Comment 67. John R.F. Baer, Keck, Mahin & Cate ("Baer")
RR Comment 68. Lynn Scott ("Scott")
RR Comment 69. Eversheds ("Eversheds")
RR Comment 70. Brownstein Zeidman (*see supra,* Comment 33)
RR Comment 71. Penny Ward, Baker & McKenzie ("Ward")
RR Comment 72. Matthias Stein ("Stein")
RR Comment 73. Byron Fox, Hunton & Williams ("Fox")
RR Comment 74. Papa Johns Pizza ("Papa Johns")
RR Comment 75. Harold L. Kestenbaum (*See supra,* Comment 14)

Rule Review September 1995 Public Workshop Conference

Panelists

Harold Brown, Brown & Stadfeld ("Brown")
Sam Damico, Q.M. Marketing, Inc. ("Damico")
Connie B. D'Imperio, Color Your Carpet, Inc. ("D'Imperio)
Eric Ellman ("Ellman"), Direct Selling Assocation ("DSA")
Mark B. Forseth, Locke Purnell Rain Harrell ("Forseth")
Mike Gason, Barkely & Evergreen ("Gaston")
Susan Kezios, American Franchisee Association ("AFA") ("Kezios")
William Kimball, Iowa Coalition for Responsible Franchising ("Kimball")
Warren Lewis, Lewis & Trattner ("Lewis")
Steven Maxey ("Maxey"), North American Securities Administrators Association ("NASAA")
Joyce G. Mazero, Locke Purnell Rain Harrell ("Mazero")
Barry Pineles ("Pineles"), U.S. Small Business Administration ("SBA Advocacy")
Robert Purvin, American Association of Franchisees & Dealers ("AAFD") ("Purvin")
Steven Rabenberg, Explore St. Louis ("Rabenberg")
Matthew R. Shay ("Shay"), International Franchise Association ("IFA")
Neil A. Simon, Hogan & Hartson ("Simon")
Robin Spencer ("Spencer"), representing American Franchisee Association
Leonard Swartz, Arthur Anderson & Co. ("Swartz")
John Tifford, Brownstein Zeidman & Lore
Ronnie Volkening ("Volkening"), The Southland Corp. ("Southland")
Dennis E. Wieczorek, Rudnick & Wolfe ("Wieczorek")
William J. Wimmer (, Iowa Coalition for Responsible Franchising "Wimmer")

Public Participants

Peter Denzen ("Denzen")
Bob Hessler, Wendy's ("Hessler")
Chris Huke, SC Promotions ("Huke")
Michael Jorgensen ("Jorgensen")
Robert L. Perry ("Perry")
Brian Schnell, Gray, Plant Mooty ("Schnell")

March 1996 Public Workshop Conference

Panelists

Kay M. Ainsley, Ziebart Intl, Corp. ("Ainsley")
John R.F. Baer, Keck, Mahin & Cate ("Baer")

Michael Brennan, Rudnick & Wolfe ("Brennan")
Joel R. Buckberg, HFA, Inc. ("Buckberg")
David A. Clanton, Baker & McKenzie ("Clanton")
Kenneth R. Costello, Loeb & Loeb ("Costello")
Edward J. Fay, Kwik Kopy Corp. ("Fay")
Mark B. Forseth, Locke Purnell Rain Harrell ("Forseth")
Byron E. Fox, Hunton & Willaims ("Fox")
Bruce Harsh, International Trade Specialist, U.S. Department of Commerce ("Harsh")
Arnold Janofsky, Precision Tune ("Janofsky")
Susan P. Kezios ("Kezios"), American Franchisee Association ("AFA")
Alex S. Konigsberg, QC (, Lapoint Rosenstein "Konigsberg")
Andrew P. Loewinger, Abraham Pressman & Bauer ("Loewinger")
H. Bret Lowell, Brownstein Zeidman ("Lowell")
John Melle, Office of U.S. Trade Representative ("Melle")
Raymond L. Miolla, Burger King Corp. ("Miolla")
Alex Papadakis, Hurt Sinisi Papadakis ("Papadakis")
Matthew R. Shay ("Shay"), International Franchise Association ("IFA")
Neil A. Simon, Hogan & Hartson ("Simon")
Leonard Swartz, Arthur Anderson & Co. ("Swartz")
Greg L. Walther, Outback Steakhouse Intl ("Walther")
Dennis E. Wieczorek, Rudnick & Wolfe ("Wieczorek")
Erik B. Wulff, Hogan & Hartson ("Wulff")
Philip F. Zeidman ("Zeidman")
Carl Zwisler, Keck, Mahin & Cate ("Zwisler")

Public Participants

Jeff Brams, Sign-A-Rama and Shipping Connections ("Brams")
Pamela Mills, Baker & McKenzie ("Mills")

ATTACHMENT B

PROPOSED FINAL REVISED RULE

PART 436 – DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING

Subpart A – Definitions

Sec.

Subpart B – Obligations of Franchisors and Other Franchise Sellers

Subpart C – Contents of a Disclosure Document

Subpart D – Instructions

Subpart E – Exemptions

Subpart F – Prohibitions

Subpart G – Other Provisions

Authority: 15 U.S.C. 41-58.

Subpart A – Definitions

§ 436.1 Definitions.

Unless stated otherwise, the following definitions apply throughout this Rule:

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

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

(c) Confidentiality clause means any contract, order, or settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor's system with any prospective franchisee. It does not include confidentiality clauses that protect franchisor's trademarks or other proprietary information.

(d) Disclose, state, describe, and list mean to present all material facts accurately, clearly, concisely, and legibly in plain English.

(e) Financial performance representation means any oral, written, or visual representation to a prospective franchisee, including a representation in the general media that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. A chart, table, or mathematical calculation that shows possible results based on a combination of variables is a financial performance representation.

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

(g) Fractional franchise means a franchise relationship that satisfies the following criteria 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 have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20 percent of the franchisee's total dollar volume in sales during the first year of operation.

(h) 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 that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;

(2) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, or provides significant assistance in the franchisee's method of operation; and

(3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

(i) Franchise seller means a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. It does not

include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.

(j) Franchisee means any person who is granted a franchise.

(k) Franchisor means any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors.

(l) Lease department means an arrangement whereby a retailer licenses or otherwise permits a seller to conduct business from the retailer's location where the seller purchases no goods, services, or commodities directly or indirectly from: (1) the retailer; (2) a person the retailer requires the seller to do business with; or (3) a retailer-affiliate if the retailer advises the seller to do business with the affiliate.

(m) Parent means an entity that controls the franchisor directly, or indirectly through one or more subsidiaries.

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

(o) 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.

(p) Predecessor means a person from whom the franchisor acquired, directly or indirectly, the major portion of the franchisor's assets.

(q) Principal business address means the street 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.

(r) 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.

(s) Required payment means all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease.

(t) Sale of a franchise includes an agreement whereby a person obtains a franchise from a franchise seller for value by purchase, license, or otherwise. It does not include extending or renewing an existing franchise agreement where there has been 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. It also does not include the transfer of a franchise by an existing franchisee where the franchisor has had no significant involvement with the prospective transferee. A franchisor's approval or disapproval of a transfer alone is not deemed to be significant involvement.

(u) Signature means a person's affirmative step to authenticate his or her identity. It includes a person's handwritten signature, as well as a person's use of security codes, passwords, electronic signatures, and similar devices to authenticate his or her identity.

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

(w) Written or in writing means any document or 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 document; information on computer disk or CD-ROM; information sent via email; or information posted on the Internet. It does not include mere oral statements.

Subpart B – Obligations of Franchisors and Other Franchise Sellers

§ 436.2 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 Subpart E of this Rule, it is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act:

(a) For any franchisor to fail to furnish a prospective franchisee with a copy of the franchisor's current disclosure document, as described in Subparts C and D, at least 14 days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale.

(b) For any franchisor to alter unilaterally and materially the terms and conditions of the basic franchise agreement attached to the disclosure document without furnishing the prospective franchisee with a copy of the revised franchise agreement, and any related agreements, at least seven days before the prospective franchisee signs the revised franchise agreement. Changes to a franchise agreement that result solely from negotiations initiated by the prospective franchisee do not trigger this seven-day period.

(c) For purposes of paragraphs 436.2(a) and (b) of this section, the franchisor has furnished the documents by the required date if: (1) a copy of the document was hand-delivered,

faxed, emailed, or otherwise delivered to the prospective franchisee by the required date; (2) directions for accessing the document on the Internet were provided to the prospective franchisee by the required date; or (3) a paper or tangible electronic copy (for example, computer disk or CD-ROM) was sent to the address specified by the prospective franchisee by first-class U.S. mail at least three days before the required date.

(d) For any franchisor to fail to include the information and follow the instructions in Subparts C and D when preparing the disclosure document to be furnished to a prospective franchisee. Any other franchise seller will be liable for the violation of these Subparts if they either directly participated in them or had the authority to control them.

Subpart C – The Contents of a Disclosure Document

§ 436.3 Cover page.

Begin the disclosure document with a cover page, stating the following in the order and form shown below:

(a) The title "FRANCHISE DISCLOSURE DOCUMENT" in capital letters and bold type;

(b) The franchisor's name, type of business organization, principal business address, telephone number, and, if applicable, email address and primary home page address;

(c) A sample of the primary business trademark that the franchisee will use in its business;

(d) A brief description of the franchised business;

(e) The following statements:

(1) The total investment necessary to begin operation of a [franchise system name]

franchise is [the total amount of Item 7], including [the total amount in Item 5] that must be paid to the franchisor.

(2) This disclosure document summarizes certain provisions of your 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 make any payment in connection with the franchise sale.

(3) Buying a franchise is a complex investment. The information in this disclosure document can help you make up your mind. Information comparing franchisors is available. Call your state agency or your public library for sources of information. More information on franchising, such as "A Consumer's Guide to Buying a Franchise," is available from the FTC. You can contact the FTC at 1-877-FTC-HELP or by writing to the FTC at 600 Pennsylvania Avenue, NW, Washington, DC 20580. You can also visit the FTC's home page at www.ftc.gov for additional information. In addition, there may be laws on franchising in your state. Ask your state agencies about them. [The following sentence in bold type] Note, however, that no governmental agency has verified the information contained in this document.

(4) You should also know that the terms of your contract will govern your franchise relationship. Don't rely on the disclosure document 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) The issuance date.

(f) A franchisor may include the following statement between the statements set out at paragraphs 436.3(e)(2) and (3) of this section: "You may wish to receive your disclosure document in another format that is more convenient for you. To discuss the availability of disclosures in different formats, contact [name or office] at [address] and [telephone number]."

(g) Franchisors may include additional disclosures on the cover page, on a separate cover page, or addendum to comply with 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

Exhibits

§ 436.5 Disclosure items.

(a) Item 1: The Franchisor, and any Parent, Predecessors, and Affiliates.

Disclose:

(1) The name and principal business address of the franchisor; any parent; and any affiliate that offer franchises in any line of business or provide products or services to the franchisees of the franchisor.

(2) The name and principal business address of any predecessors during the 10-year period immediately before the close of the franchisor's most recent fiscal year.

(3) The name that the franchisor uses and any names it intends to use to conduct business.

(4) The principal business address of the franchisor's agent for service of process.

(5) The type of business organization used by the franchisor (for example, corporation, partnership) and the state in which it was organized.

(6) The following information about the franchisor's business and the franchises offered:

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

(ii) The franchisor's other business activities;

(iii) The business the franchisee will conduct;

(iv) The general market for the product or service the franchisee will offer. 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; and

(vi) A general description of the competition, including competition from any entity in which an officer of the franchisor owns an interest.

(7) The prior business experience of the franchisor; any predecessors; and any affiliates that offer franchises in any line of business or provide products or services to the franchisees of the franchisor, including:

(i) The length of time each has conducted the type of business the franchisee will operate;

(ii) The length of time each has offered franchises providing the type of business the franchisee will operate; and

(iii) Whether each has offered franchises in other lines of business. If so, include:

(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 franchises in each other line of business.

(b) Item 2: Business Experience.

Disclose by name and position the franchisor's directors, trustees, general partners, principal officers, and any other individuals who occupy a similar status or perform similar functions. In addition, disclose any other executives and subfranchisors who will have management responsibility relating to the sale or operation of franchises offered by this

document. For each person listed in this section, state his or her principal positions and employers during the past five years, including each position's starting date, ending date, and location.

(c) Item 3: Litigation.

(1) Disclose whether the franchisor; a parent who guarantees the franchisor's performance; a predecessor; an affiliate who offers franchises under the franchisor's principal trademark; and any person identified in paragraph 436.5(b) of this section:

(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;

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

(ii) Was a party to any material civil action involving the franchise relationship in the last fiscal year. For purposes of this section, "franchise relationship" means contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business (such as royalty payment and training obligations). It does not include actions involving third parties, such as suppliers or indemnification for tort liability.

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

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

(B) Been held liable in a civil action, or 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. "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.

(2) Disclose whether the franchisor; a parent who guarantees the franchisor's performance; a predecessor; an affiliate who has offered or sold franchises in any line of business within the last 10 years; or any other person identified in paragraph 436.5(b) of this section 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.

(3) For each action identified in this subsection, state the title, case number or citation, the initial filing date, the names of the parties, the forum, and the relationship of the opposing party to the franchisor (for example, 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.[1] Provided, however, for franchisor-initiated litigation, franchisors may list individual suits under one common heading, which will serve as the summary (for example, royalty collection suits). In addition, state:

[1] Franchisors may include a summary opinion of counsel concerning any action if counsel consent to use the summary opinion and the full opinion is attached to the disclosure document.

(i) For pending actions, the status of the action.

(ii) For prior actions, the date when the judgment was entered and any damages or settlement terms.[2]

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

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

(d) Item 4: Bankruptcy.

(1) Disclose whether the franchisor, any parent, predecessor, affiliate, officer, general partner, or any other individual who occupies a similar status or performs similar functions 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.

(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

---

[2] If a settlement agreement must be disclosed in this Item, all material settlement terms must be disclosed, whether or not the agreement is confidential. However, franchisors need not disclose the terms of confidential settlements entered into before commencing franchise sales. Further, any franchisor who has historically used only the Franchise Rule format, or who is new to franchising, need not disclose confidential settlements entered prior to the effective date of this Rule.

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, state:

(i) The current name, address, and principal place of business of the debtor;

(ii) Whether the debtor is the franchisor. If not, state the relationship of the debtor to the franchisor (for example, affiliate, officer); and

(iii) The date of the original filing and the material facts, including 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.

(e) Item 5: Initial Fees Paid to Franchisor.

Disclose the initial fees and any conditions under which these fees are refundable. If the initial fees are not uniform, disclose the range or formula used to calculate the initial fees paid in the fiscal year before the issuance date and the factors that determined the amount. For this section, "initial fees" means all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens, whether payable in lump sum or installments. Disclose installment payment terms in this subsection or in paragraph 436.5(j) of this section.

(f) Item 6: Other Fees.

Disclose, in the tabular form shown below, all other fees that the franchisee must pay to the franchisor or its affiliates, that the franchisor or its affiliates impose or collect in whole or in part for a third party, or that the franchisee is required to pay directly to a third party. Include any formula used to compute the fees.[3]

Item 6 Table:

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

(1) In column (1), list the type of fee (for example, 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), state the amount of the fee. If the payment is made directly to a third party, then state either the amount of the fee or, if unknown, the following sentence: "The amount of the fee is unknown and may vary depending upon factors, such as the third-party supplier selected."

(3) In column (3), state the due date for each fee.

(4) In column (4), include remarks, definitions, or caveats that elaborate on the information in the table. If remarks are long, franchisors may use footnotes instead of the

[3] 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."

remarks column. If applicable, include the following information in the remarks column or in a footnote:

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

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

(iii) Whether the fees are non-refundable or describe the circumstances when the fees are refundable;

(iv) Whether the fees are uniformly imposed; and

(v) 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. State the title "Your Estimated Initial Investment" in bold type. Franchisors may include additional expenditure tables to show expenditure variations caused by differences such as in site location and premises size.

Item 7 Table:

YOUR ESTIMATED INITIAL INVESTMENT

(1) Type of expenditure	(2) Amount	(3) Method of payment	(4) When due	(5) To whom payment is to be made
Total.				

(1) In column (1):

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

(A) The initial franchise fee;

(B) Training expenses;

(C) Real property, whether purchased or leased;

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

(E) Inventory to begin operating; and

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

(ii) List separately and by name any other specific required payments (for example, additional training, travel, or advertising expenses) that the franchisee must make to begin operations.

(iii) Include a category titled "Additional funds – [initial period]" for any other required expenses the franchisee will incur before operations begin and during the initial period of operations. State the initial period. A reasonable initial period is at least three months or a

reasonable period for the industry. Describe in general terms the factors, basis, and experience that the franchisor considered or relied upon in formulating the amount required for additional funds.

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

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

(4) In column (4), state the due date.

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

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

(7) In a footnote, state:

(i) Whether each payment is non-refundable, or describe the circumstances when each payment is refundable.

(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 interest rate, rate factors, and the estimated loan repayments. Franchisors may refer to paragraph 436.5(j) of this section for additional details.

(h) Item 8: Restrictions on Sources of Products and Services.

Disclose the franchisee's obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items

related to establishing or operating the franchised business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor's specifications. Include obligations to purchase imposed by written agreement or by the franchisor's practice.[4] For each applicable obligation, state:

(1) The good or service required to be purchase or leased.

(2) Whether the franchisor or its affiliates are approved suppliers or the only approved suppliers of that good or service.

(3) Any supplier in which an officer of the franchisor owns an interest.

(4) How the franchisor grants and revokes approval of alternative suppliers, including:

(i) Whether the franchisor's criteria for approving suppliers are available to franchisees;

(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 to purchase from alternative suppliers;

(iv) The time period in which the franchisee will be notified of approval or disapproval; and

(v) How approvals are revoked.

---

[4] Franchisors may include the reason for the requirement. Franchisors need not disclose in this Item the purchase or lease of goods or services provided as part of the franchise without a separate charge (such as initial training, if the cost is included in the franchise fee). Describe such fees in Item 5 of this section. Do not disclose fees already described in paragraph 436.5(f) of this section.

(5) Whether the franchisor issues specifications and standards to franchisees, subfranchisees, or approved suppliers. If so, describe how the franchisor issues and modifies specifications.

(6) Whether the franchisor or its affiliates will or may derive revenue or other material consideration from required purchases or leases by franchisees. If so, describe the precise basis by which the franchisor or its affiliates will or may derive that consideration by stating:[5]

(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 that are from required purchase or leases; and

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

(7) The estimated proportion of these required purchases and leases by the franchisee to all purchases and leases by the franchisee of goods and services in establishing and operating the franchised businesses.

(8) If a designated supplier will make payments to the franchisor from franchisee purchases, disclose the basis for the payment (for example, specify a percentage or a flat

---

[5] Take figures from the franchisor's most recent annual audited financial statement required in paragraph 436.5(u) of this section. 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.

amount). For purposes of this disclosure, a "payment" includes the sale of similar goods or services to the franchisor at a lower price than to franchisees.

(9) The existence of purchasing or distribution cooperatives.

(10) Whether the franchisor negotiates purchase arrangements with suppliers, including price terms, for the benefit of franchisees.

(11) Whether the franchisor provides material benefits (for example, 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 franchisee's principal obligations. Cross-reference each listed obligation with any applicable section of the franchise or other agreement and with the relevant disclosure document provision. If a particular obligation is not applicable, state "Not Applicable." Include additional obligations, as warranted.

Item 9 Table:

[In bold] 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.

Obligation	Section in agreement	Disclosure document item
a. Site selection and acquisition/lease		
b. Pre-opening purchase/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 of each financing arrangement, including leases and installment contracts, that the franchisor, its agent, or affiliates offer directly or indirectly to the franchisee.[6] The franchisor may summarize the terms of each financing arrangement in tabular

[6] 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.

form, using footnotes to provide additional information. For a sample Item 10 table, see Appendix A of this Rule. For each financing arrangement, state:

(i) What the financing covers (for example, 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).[7]

(ii) The identity of each lender providing financing and their relationship to the franchisor (for example, 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.

(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, state 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; and

---

[7] Include sample copies of the financing documents as an exhibit to paragraph 436.5(v) of this section. Cite the section and name of the document containing the financing terms and conditions.

(D) Liabilities from cross defaults such as those resulting directly from non-payment, or indirectly from the loss of business property.

(x) Other material financing terms.

(2) Disclose whether the loan agreement requires franchisees to waive defenses or other legal rights (for example, confession of judgment), or bars franchisees 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, state:

(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 placing 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 you with any assistance."

(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. If provided, state:

(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 in which the franchisee selects a site. If so, state further whether and how the franchisor must approve a franchisee-selected site;

(C) The factors that the franchisor considers in selecting or approving sites (for example, general location and neighborhood, traffic patterns, parking, size, physical characteristics of existing buildings, and lease terms); and

(D) The time limit for the franchisor to locate or approve or disapprove the site and 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.

(v) Providing for necessary equipment, signs, fixtures, opening inventory, and supplies. If provided, state:

(A) Whether the franchisor provides these items directly or only 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 earlier of 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 the franchisee will offer 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, including 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 (for example, 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) The circumstances when the franchisor will permit franchisees to use their own advertising material.

(iii) 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) Whether the franchisee must participate in a local or regional advertising cooperative. If so, state:

(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 must contribute a different amount or at a different rate;

(C) Whether the franchisor-owned outlets must contribute to the fund and, if so, whether those contributions are on the same basis as those for franchisees;

(D) Who is responsible for administering the cooperative (for example, franchisor, franchisees, or advertising agency);

(E) Whether cooperatives must operate from written governing documents and whether the documents are available for the franchisee to review;

(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) Whether the franchisee must participate in any other advertising fund. If so, state:

(A) Who contributes to the fund;

(B) How much the franchisee must contribute to the fund and whether other franchisees must contribute a different amount or 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 not all advertising funds are spent in the fiscal year in which they accrue, how the franchisor uses the remaining amount, including whether franchisees receive a periodic accounting of how advertising fees are spent.

(vii) 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, including the types of data to be generated or stored in these systems, and state the following:

(i) The cost of purchasing or leasing the systems;

(ii) Any obligation of the franchisor, any affiliate, or third party to provide ongoing maintenance, repairs, upgrades, or updates;

(iii) Any obligations of the franchisee to upgrade or update any system during the term of the franchise, and, if so, any contractual limitations on the frequency and cost of the obligation;

(iv) The annual cost of any optional or required maintenance, updating, upgrading, or support contracts; and

(v) Whether the franchisor will have independent access to the information that will be generated or stored in any electronic cash register or computer system. If so, describe the information that the franchisor may access and whether there are any contractual limitations on the franchisor's right to access the information.

(6) Disclose the table of contents of the franchisor's operating manual provided to franchisees as of the franchisor's last fiscal year-end or a more recent date. State the number of pages devoted to each subject and the total number of pages in the manual as of this date. This

disclosure may be omitted if the franchisor offers the prospective franchisee the opportunity to view the manual before buying 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 training program in the tabular form shown below:

Item 11 Table

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) State further:

(A) How often training classes are held and the nature of the location or facility where training is held (for example, company, home, office, franchisor-owned store);

(B) The nature of instructional materials and the instructor's experience, including the instructor's length of experience in the field and with the franchisor. State only experience relevant to the subject taught and the franchisor's operations;

(C) Any charges franchisees must pay for training and who must pay travel and living expenses of the training program enrollees;

(D) Who may and who must attend 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 signing the agreement or before opening 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

(E) Whether additional training programs or refresher courses are required.

(l) Item 12: Territory.

Disclose:

(1) Whether the franchise is for a specific location or a location to be approved by the franchisor;

(2) Any minimum territory granted to the franchisee (for example, a specific radius, a distance sufficient to encompass a specified population, or another specific designation);

(3) The conditions under which the franchisor will approve the relocation of the franchised business or the franchisee's establishment of additional franchised outlets;

(4) Franchisee options, rights of first refusal, or similar rights to acquire additional franchises; and

(5) Whether the franchisor grants an exclusive territory.

(i) If the franchisor does not grant an exclusive territory, state: "You will not receive an exclusive territory. You may face competition from other franchisees or franchisor-owned outlets, or from other channels of distribution or competitive brands that we control."

(ii) If the franchisor grants an exclusive territory, disclose:

(A) Whether continuation of territorial exclusivity depends on achieving a certain sales volume, market penetration, or other contingency, and the circumstances when the franchisee's territory may be altered. Describe 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 (for example, a population increase in the territory giving the franchisor the right to grant an additional franchise in the area), and the effect of such modifications on the franchisee's rights.

(6) For all territories (exclusive and non-exclusive):

(i) Any restrictions on the franchisor from soliciting or accepting orders from consumers inside the franchisee's territory, including:

(A) Whether the franchisor or an affiliate has used or reserves the right to use other channels of distribution, such as through the Internet, catalog sales, telemarketing, or other direct marketing sales, to make sales within the franchisee's territory using the franchisor's principal trademarks;

(B) Whether the franchisor or an affiliate has used or reserves the right to use other channels of distribution, such as through the Internet, catalog sales, telemarketing, or other direct marketing, to make sales within the franchisee's territory of products or services under trademarks different from the ones the franchisee will use under the franchise agreement; and

(C) Any compensation that the franchisor must pay for soliciting or accepting orders from inside the franchisee's territory.

(ii) Any restrictions on the franchisee from soliciting or accepting orders from consumers outside of his or her territory, including whether the franchisee has the right to use other channels of distribution, such as through the Internet, catalog sales, telemarketing, or other direct marketing, to make sales outside of his or her territory.

(iii) If the franchisor or an affiliate operates, franchises, or has plans to operate or franchise a business under a different trademark and that business sells or will sell goods or services similar to those the franchisee will offer, describe:

(A) The similar goods and services;

(B) The different trademark;

(C) Whether outlets will be franchisor owned or operated;

(D) Whether the franchisor or its franchisees who use the different trademark will solicit or accept orders within the franchisee's territory;

(E) The timetable for the plan;

(F) How the franchisor will resolve conflicts between the franchisor and franchisees and between the franchisees of each system regarding territory, customers, and franchisor support; and

(G) The principal business address of the franchisor's similar operating business. If it is the same as the franchisor's principal business address stated in paragraph 436.5(a) of this section, 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 this Item, "principal trademark" means the primary trademarks, service marks, names, logos, and commercial symbols the franchisee will use to identify the franchised business. It may not include every trademark the franchisor owns.

(2) Disclose whether each principal trademark is registered with the United States Patent and Trademark Office. If so, state:

(i) The date and identification number of each trademark registration;

(ii) Whether the franchisor has filed all required affidavits;

(iii) Whether any registration has been renewed; and

(iv) Whether the principal trademarks are registered on the Principal or Supplemental Register of the U.S. Patent and Trademark Office.

(3) If the principal trademark is not registered with the United States Patent and Trademark Office, state whether the franchisor has filed any trademark application, including any "intent to use" application or an application based on actual use. If so, state the date and identification number of the application.

(4) If the trademark is not registered on the Principal Register of the U.S. Patent and Trademark Office, state: "Our trademark is unregistered. Therefore, our right to use the trademark may be challenged. If so, franchisees may have to change to an alternative trademark, which may increase your operating costs."

(5) Disclose any currently effective material determinations of the U.S. Patent and Trademark Office, the Trademark Trial and Appeal Board, or any state trademark administrator

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 ownership, use, or licensing of the trademark.

(6) Disclose any pending material federal or state court litigation regarding the franchisor's use or ownership rights in a trademark. For each pending action, disclose:[8]

(i) The forum and case number;

(ii) The nature of claims made opposing the franchisor's use of the trademark or by the franchisor opposing another person's use of the trademark; and

(iii) Any effective court or administrative agency ruling in the matter.

(7) Disclose any currently effective agreements that significantly limit the franchisor's rights to use or license the use of trademarks listed in this Rule 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 agreement may affect the franchisee;

(iii) The agreement's duration;

(iv) The parties to the agreement;

(v) The circumstances when the agreement may be canceled or modified; and

---

[8] The franchisor may include an attorney's opinion relative to the merits of litigation or of an action if the attorney issuing the opinion consents to its use. The text of the disclosure may include a summary of the opinion if the full opinion is attached and the attorney issuing the opinion consents to the use of the summary.

(vi) All other material terms.

(8) Disclose:

(i) 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;

(ii) 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;

(iii) 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;

(iv) 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

(v) The franchisee's rights under the franchise agreement if the franchisor requires the franchisee to modify or discontinue using a trademark.

(9) Disclose whether the franchisor knows of either superior prior rights or infringing uses that could materially affect the franchisee's use of the principal trademarks in the state where the franchised business will be located. For each use of a principal trademark that the franchisor believes is an infringement that could materially affect the franchisee's use of a trademark, disclose:

(i) The nature of the infringement;

(ii) The locations where the infringement is occurring;

(iii) The length of time of the infringement (to the extent known); and

(iv) Any action taken or anticipated 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, including:

(i) A description of the patent or copyright and its relationship to the franchise; and

(ii) 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) The type of patent or patent application (for example, 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 any court.[9]

(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 agreement may affect the franchisee, 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, including:

(i) Whether the franchisee must notify the franchisor of any infringement claims or whether the franchisee's notification is discretionary;

(ii) Whether the franchise agreement requires the franchisor to take affirmative action when notified of infringement;

(iii) Who has the right to control litigation;

(iv) 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;

(v) Any requirement that the franchisee modify or discontinue using the subject matter covered by the patent or copyright; and

---

[9] If counsel consents, the franchisor may include a counsel's opinion or a summary of the opinion if the full opinion is attached.

(vi) The franchisee's rights under the franchise agreement if the franchisor requires the franchisee to modify or discontinue using the subject matter covered by the patent or copyright.

(6) If the franchisor knows of any patent or copyright infringement that could materially affect the franchisee, disclose:

(i) The nature of the infringement;

(ii) The locations where the infringement is occurring;

(iii) The length of time of the infringement (to the extent known); and

(iv) Any 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 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) Limits on who 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 (for example, 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 access to customers, including:

(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; and

(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.

(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.

(1) Describe briefly each contractual provision. If a particular item is not applicable, state "Not Applicable."

(2) If the agreement is silent about 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 the policy and state whether the policy is subject to change.

(3) In the summary column for provision (c), state what the term "renewal" means for your franchise system, including, if applicable, a statement that franchisees may be asked to sign a contract with different terms and conditions than their original contract.

Item 17 Table

[In bold] 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 - non-curable 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:

(1) Any compensation or other benefit given or promised to a public figure arising from either the use of the public figure in the franchise name or symbol, or the public figure's endorsement or recommendation of the franchise to prospective franchisees.

(2) The extent to which the public figure is involved in the management or control of the franchisor. Describe the public figure's position and duties in the franchisor's business structure.

(3) The public figure's total investment in the franchisor, including the amount the public figurer contributed in services performed or to be performed. State the type of investment (for example, common stock, promissory note).

(4) For purposes of this subsection, 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.

(s) Item 19: Financial Performance Representations.

(1) Begin by stating the following:

> The FTC's Franchise Rule permits a franchisor to disclose 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 the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about performance at a particular location or under particular circumstances.

(2) If a franchisor does not provide any financial performance representation in Item 19, also state:

> This franchisor does not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name and address], 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 the representations are made and must state the representations in the Item 19 disclosure. The franchisor must also disclose the following:

(i) Whether the representation is an historic financial performance representation about the franchise system's existing outlets, or a subset of those outlets, or is a forecast of the prospective franchisee's future financial performance.

(ii) If the representation relates to 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 (for example, 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 operated, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated);

(B) The dates when 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 used in arriving at the representation;

(E) Of those outlets whose data were used in arriving at the representation, the number and percent that actually attained or surpassed the stated results; and

(F) Characteristics of the included outlets, such as those characteristics noted in § (s)(3)(ii)(A) of this section, 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.

(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.

(4) If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with this section, provided the information is given only to potential purchasers of that outlet.

(5) If a franchisor furnishes financial performance information according to this section, 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 requirements of paragraph (s)(3)(i)-(iv) of this section; and

(iv) Be furnished to the prospective franchisee.

(t) Item 20: Outlets and Franchisee Information.

(1) Disclose, in the tabular form shown below, the total number of franchised and company-owned outlets for each of the franchisor's last three fiscal years. For purposes of this subsection, "outlet" 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 to this Rule.

Table No. 1

Systemwide Outlet Summary
For years [ ] to [ ]

Column 1 Outlet Type	Column 2 Year	Column 3 Outlets at the Start of the Year	Column 4 Outlets at the End of the Year	Column 5 Net Change
Franchised	2002			
	2003			
	2004			
Company-Owned	2002			
	2003			
	2004			
Total Outlets	2002			
	2003			
	2004			

(i) In column (1), include three outlet categories titled “franchised,” “company-owned, and “total outlets.”

(ii) In column (2), state the last three fiscal years.

(iii) In column (3), state the total number of each type of outlet operating at the beginning of each fiscal year.

(iv) In column (4), state the total number of each type of outlet operating at the end of each fiscal year.

(v) In column (5), state the net change, and indicate whether the change is positive or negative, for each type of outlet during each fiscal year.

(2) Disclose, in the form of the tables listed below, the number of franchised and company-owned outlets and changes in the number and ownership of outlets for each state during each of the last three fiscal years. Except as noted below, each change in ownership shall be reported only once in the following tables. If multiple events occurred in the process of transferring ownership of an outlet, report the event that occurred last in time. Where a single outlet changed ownership two or more times during the same fiscal year, report the event that happened last and use footnotes to explain the preceding events.

(i) Disclose, in the tabular form shown below, the total number of franchised outlets transferred in each state during each of the franchisor's last three fiscal years. For purposes of this subsection, "transfer" means the acquisition of a controlling interest in a franchised outlet, during its term, by a person other than the franchisor or an affiliate. A sample Item 20(2) Table is attached as Appendix C to this Rule.

Table No. 2

Transfers of Franchised Outlets
For years [ ] to [ ]

Column 1 State	Column 2 Year	Column 3 Number of Transfers
	2002	
	2003	
	2004	
	2002	
	2003	
	2004	
Total	2002	
	2003	
	2004	

(A) In column (1), list each state with one or more franchised outlets.

(B) In column (2), state the last three fiscal years.

(C) In column (3), state the total number of completed transfers in each state during each fiscal year.

(ii) Disclose, in the tabular form shown below, the status of franchisee-owned outlets in each state for each of the franchisor's last three fiscal years. A sample Item 20(3) Table is attached as Appendix D to this Rule.

Table No. 3

Status of Franchised Outlets
For years [ ] to [ ]

Col.1 State	Col.2 Year	Col. 3 Outlets at Start of Year	Col. 4 Outlets Opened	Col. 5 Termina-tions	Col. 6 Non-Renewals	Col. 7 Reacquired by Franchisor	Col. 8 Ceased Opera-tions-Other Reasons	Col. 9 Outlets at End of the Year
	2002							
	2003							
	2004							
	2002							
	2003							
	2004							
Totals								

(A) In column (1), list each state with one or more franchised outlets.

(B) In column (2), state the last three fiscal years.

(C) In column (3), state the total number of franchised outlets in each state at the start of each fiscal year.

(D) In column (4), state the total number of franchised outlets opened in each state during each fiscal year. Include both new outlets and existing company-owned outlets that a franchisee purchased from the franchisor. (Also report the number of existing company-owned outlets that are sold to a franchisee in Column 7 of Table 4).

(E) In column (5), state the total number of franchised outlets that were terminated in each state during each fiscal year. For purposes of this subsection, “termination” means the franchisor’s termination of a franchise agreement prior to the end of its term and without

providing any consideration to the franchisee (whether by payment or forgiveness or assumption of debt).

(F) In column (6), state the total number of non-renewals in each state during each fiscal year. For purposes of this subsection, "non-renewal" occurs when the franchise agreement for a franchised outlet is not renewed at the end of its term.

(G) In column (7), state the total number of franchised outlets reacquired by the franchisor in each state during each fiscal year. For purposes of this subsection, a "reacquisition" means the franchisor's acquisition for consideration (whether by payment or forgiveness or assumption of debt) of a franchised outlet during its term. (Also report franchised outlets reacquired by the franchisor in column 5 of Table 4).

(H) In column (8), state the total number of outlets in each state not operating as one of the franchisor's outlets at the end of each fiscal year for reasons other than termination, non-renewal, or reacquisition by the franchisor.

(I) In column (9), state the total number of franchised outlets in each state at the end of the fiscal year.

(iii) Disclose, in the tabular form shown below, the status of company-owned outlets in each state for each of the franchisor's last three fiscal years. A sample Item 20(4) Table is attached as Appendix E to this Rule.

Table No. 4

Status of Company-Owned Outlets
For years [ ] to [ ]

Col. 1 State	Col. 2 Year	Col. 3 Outlets at Start of the Year	Col. 4 Outlets Opened	Col. 5 Outlets Reacquired From Franchisee	Col. 6 Outlets Closed	Col. 7 Outlets Sold to Franchisee	Col. 8 Outlets at End of the Year
	2002						
	2003						
	2004						
	2002						
	2003						
	2004						
Totals	2002						
	2003						
	2004						

(A) In column (1), list each state with one or more company-owned outlets.

(B) In column (2), state the last three fiscal years.

(C) In column (3), state the total number of company-owned outlets in each state at the start of the fiscal year.

(D) In column (4), state the total number of company-owned outlets opened in each state during each fiscal year.

(E) In column (5), state the total number of franchised outlets reacquired from franchisees in each state during each fiscal year.

(F) In column (6), state the total number of company-owned outlets closed in each state during each fiscal year. Include both actual closures and instances when an outlet ceases to operate under the franchisor's trademark.

(G) In column (7), state the total number of company-owned outlets sold to franchisees in each state during each fiscal year.

(H) In column (8), state the total number of company-owned outlets operating in each state at the end of each fiscal year.

(3) Disclose, in the tabular form shown below, projected new franchised outlets. A sample Item 20(5) Table is attached as Appendix F to this Rule.

Table No. 5

Projected Openings As Of [Last Day of Last Fiscal Year]

Column 1 State	Column 2 Franchise Agreements Signed But Outlet Not Opened	Column 3 Projected New Franchised Outlet In The Next Fiscal Year	Column 4 Projected New Company-Owned Outlet In the Current Fiscal Year
Total			

(i) In column (1), list each state where one or more franchised or company-owned outlets are located or are projected to be located.

(ii) In column (2), state the total number franchise agreements that had been signed for new outlets to be located in each state as of the end of the previous fiscal year where the outlet had not yet opened.

(iii) In column (3), state the total number of new franchised stores in each state projected to be opened during the next fiscal year.

(iv) In column (4), state the total number of new company-owned outlets in each state that are projected to be opened during the current fiscal year.

(4) If a franchisor is selling an existing franchised outlet, disclose the following additional information for that outlet for the last five fiscal years. This information may be attached as an addendum to this disclosure document.

(i) The name and last known address and telephone number of each previous owner of the outlet;

(ii) The time period when each previous owner controlled the outlet;

(iii) The reason for each previous change in ownership (for example, termination, non-renewal, voluntary transfer, ceased operations); and

(iv) The time period(s) when the franchisor retained control of the outlet (for example, after termination, non-renewal, or reacquisition).

(5) Disclose the names of all current franchisees and the address and telephone number of each of their outlets. Alternatively, disclose this information for all franchised outlets in the state, but if these franchised outlets total fewer than 100, disclose this information for franchised outlets from contiguous states and then the next closest states until at least 100 franchised outlets are listed.

(6) Disclose the name and last known home address and telephone number of every franchisee who 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.

(7) Disclose whether franchisees signed confidentiality clauses in a franchise agreement, settlement, or in any other contract, during the last three fiscal years. If so, state the following: "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." Franchisors may also disclose the number and percentage of current and former franchisees who during each of the last three fiscal years

signed agreements that include confidentiality clauses and may disclose the circumstances under which such clauses were signed.

(8) Disclose, to the extent known, the name, address, telephone number, email address, and Web address of each trademark-specific franchisee organization associated with the franchise system being offered, if such organization:

(i) Has been created, sponsored, or endorsed 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. Such organizations must renew their request for inclusion in the disclosure document annually and within 90 days after the close of the franchisor's fiscal year. The franchisor has no obligation to verify the organization's continued existence at the end of each fiscal year. Franchisors may also include the following statement: "The following independent franchisee associations have asked to be included in this disclosure document. We do not endorse these organizations and their members may not represent all franchisees in the [name of franchisor] franchise system."

(u) Item 21: Financial Statements.

(1) Include the following financial statements prepared according to United States generally accepted accounting principles, or as permitted by the Securities and Exchange Commission, or as revised by any future government mandated accounting principles. Except as provided in § (u)(2) of this section, these financial statements must be audited by an independent certified public accountant using generally accepted United States auditing principles. Present the required financial statements in a tabular form that compares at least two fiscal years.

(i) The franchisor's balance sheet for the previous two fiscal year-ends before the disclosure document issuance date. In addition, include statements of operations, stockholders equity, and cash flows for each of the franchisor's previous three fiscal years.

(ii) Instead of the disclosure required by § (u)(1)(i) of this section, the franchisor may include financial statements of any of its affiliates if the affiliate's financial statements satisfy § (u)(1)(i) of this section and the affiliate 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 need not extend to third parties. If this alternative is used, attach a copy of the guarantee to the disclosure document.

(iii) 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.

(iv) Include separate financial statements for the franchisor, subfranchisor, and any parent or other entity that commits to perform post sale obligations for the franchisor or guarantees the franchisor's obligation. Attach a copy of any guarantee to the disclosure document.

(2) A start-up franchise system that does not yet have audited financial statements, may phase-in the use of audited financial statements by providing, at a minimum, the following statements in the times indicated below:

(i) The franchisor's first partial or full fiscal year selling franchises.	An unaudited opening balance sheet.
(ii) The franchisor's second fiscal year selling franchises.	Audited balance sheet opinion as of the end of the first partial or full fiscal year selling franchises.
(iii) The franchisor's 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 § (u)(1)(i) of this section.

(iv) Start-up franchisors may phase-in the use of audited financial statements, provided the franchisor:

(A) Prepares audited financial statements as soon as practicable;

(B) Prepares unaudited statements in a format that conforms as closely as possible to audited statements; and

(C) Includes one or more years of unaudited financial statements or clearly and conspicuously discloses in this section that the franchisor has not been in business for three years or more, and cannot include all financial statements required in § (u)(1)(i) of this section.

(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: Receipts.

Include two copies of the following detachable acknowledgment of receipt in the form set out below as the last pages of the disclosure document:

(1) State the following:

Receipt

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 you sign a binding agreement or make a payment with the franchisor or an affiliate in connection with the proposed franchise sale.

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].

(2) Disclose the name, principal business address, and telephone number of each franchise seller offering the franchise.

(3) State the issuance date.

(4) If not disclosed in paragraph 436.5(a) of this section, state the name and address of the franchisor's registered agent authorized to receive service of process.

(5) State the following:

I received a disclosure document dated _____ that included the following Exhibits:

(6) List the title(s) of all attached Exhibits.

(7) Provide space for the prospective franchisee's signature and date.

(8) Franchisors may include any specific instructions for returning the receipt (for example, street address, email address, facsimile telephone number).

Subpart D – Instructions

§ 436.6 Instructions for Preparing Disclosure Documents

(a) Disclose the information required in Subpart C clearly, legibly, and concisely in a single document using plain English. The disclosures must be in a form that permits each prospective franchisee to store, download, print, or otherwise maintain the document for future reference.

(b) Respond fully to each disclosure Item. If a 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 those required or permitted by this Rule or by state law not preempted by this Rule. For the sole purpose of enhancing the prospective franchisee's ability to maneuver through an electronic version of a 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.

(d) Franchisors may prepare multi-state disclosure documents by including non-preempted, state-specific information in the text of the disclosure document or in Exhibits attached to the disclosure document.

(e) Subfranchisors shall disclose the required information about the franchisor, and, to the extent applicable, the same information concerning the subfranchisor.

(f) Before furnishing a disclosure document, the franchisor shall advise the prospective franchisee of the formats in which the disclosure document is made available, any

prerequisites for obtaining the disclosure document in a particular format, and any conditions necessary for reviewing the disclosure document in a particular format.

(g) Franchisors shall retain, and make available to the Commission upon request, a sample copy of each materially different version of their disclosure documents for three years after the close of the fiscal year when it was last used.

(h) For each completed franchise sale, franchisors shall retain a copy of the signed receipt for at least three years.

§ 436.7 Instructions For Updating Disclosures

(a) All information 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 120 days, prepare a revised disclosure document, after which a franchise seller may distribute only the revised document and no other disclosure document.

(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 of disclosure.

(c) If applicable, the annual update shall include the franchisor's first quarterly update, either by incorporating the quarterly update information into the disclosure document itself, or through an addendum.

(d) When furnishing a disclosure document, the franchise seller shall notify the prospective franchisee of any material changes that the seller knows or should have known

occurred in the information contained in any financial performance representation made in Item 19.

(e) Information that must be audited pursuant to § 436.5(u) of this Rule need not be audited for quarterly revisions; provided, however, that the franchisor states in immediate conjunction with the information that such information was not audited.

Subpart E – Exemptions

§ 436.8 Exemptions.

(a) The provisions of this Rule shall not apply if the franchisor can establish any of the following:

(1) The total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee's business is less than $500.

(2) The franchise relationship is a fractional franchise.

(3) The franchise relationship is a leased department.

(4) The franchise relationship is covered by the Petroleum Marketing Practices Act, 15 U.S.C. 2801.

(5)(i) The franchisee's estimated investment, excluding any financing received from the franchisor or an affiliate and excluding real estate costs, totals at least $1 million and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption. The acknowledgment shall state: "The franchise sale is for more than $1 million, excluding real estate costs, and thus is exempted from the Commission's Franchise Rule disclosure requirements, pursuant to 16 C.F.R. § 436.8(a)(5)(i)"; or

(ii) The franchisee (and its parent or any affiliates) is an entity that has been in business for at least five years and has a net worth of at least $5 million.

(6) One or more purchasers of at least a 50 percent ownership interest in the franchise: (1) within 60 days of the sale, has been, for at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor's franchisees or the administrator of the franchised network; or (2) within 60 days of the sale, has been, for at least two years, an owner of at least a 25 percent interest in the franchisor.

(7) There is no written document that describes any material term or aspect of the relationship or arrangement.

(b) For purposes of the exemptions set forth in this subsection, the Commission may adjust the size of the thresholds every four years based upon the Consumer Price Index.

Subpart F – Prohibitions

§ 436.9 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 covered by this Rule to:

(a) Make any claim or representation, orally, visually, or in writing, that contradicts the information required to be disclosed by this Rule.

(b) Misrepresent that any person:

(1) Purchased a franchise from the franchisor or operated a franchise of the type offered by the franchisor; or

(2) Can provide an independent and reliable report about the franchise or the experiences of any current or former franchisees.

(c) Disseminate any financial performance representations to prospective franchisees, including any representations made in the general media, unless the franchisor has a reasonable basis and written substantiation for the representation at the time the representation 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 §§ 436.5(s)(3)(ii)(B) and (E) of this Rule if the representation relates to the past performance of the franchisor's outlets; and

(2) Include a clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation.

(d) 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.

(e) Fail to furnish a copy of the franchisor's disclosure document to a prospective franchisee earlier in the sales process than required under § 436.2 of this Rule, upon reasonable request.

(f) Fail to furnish existing disclosures to a prospective purchaser of an existing franchised outlet, upon reasonable request.

(g) Fail to furnish a copy of the franchisor's most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisee signs a franchise agreement.

(h) Present for signing a franchise agreement in which the terms and conditions differ materially from those presented as an attachment to the disclosure document, unless the seller informed the prospective franchisee of the differences within a reasonable time before execution.

(i) Disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments. Provided, however, that this provision is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sale negotiations.

(j) Fail to return any funds or deposits in accordance with any conditions disclosed in the franchisor's disclosure document, franchise agreement, or any related document.

Subpart G – Other Provisions

§ 436.10 OTHER LAWS, RULES, ORDERS.

(a) The Commission does not approve or express any opinion on the legality of any matter a franchisor may be required to disclose by this Rule. Further, franchisors may have additional obligations to disclose material information to prospective franchisees under Section 5 of the Federal Trade Commission Act. The Commission intends to enforce all applicable statutes and trade regulation rules.

(b) If an outstanding FTC or court 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.

§ 436.11 SEVERABILITY.

If any provision of this regulation is stayed or held invalid, the remainder will stay in force.

Appendix A: Sample Item 10 Table – Summary of Financing Offered

Item Financed	Source of Financing	Down Payment	Amount Financed	Term (Yrs)	APR %	Monthly Payment	Prepay Penalty	Security Required	Liability Upon Default	Loss of Legal Right on Default
Initial Fee										
Land/ Constr										
Equip. Lease										
Equip. Purchase										
Opening Inventory										
Other Financing										

Appendix B: Sample Item 20(1) Table – Systemwide Outlet Summary

Systemwide Outlet Summary
For years 2002 to 2004

Column 1 Outlet Type	Column 2 Year	Column 3 Outlets at the Start of the Year	Column 4 Outlets at the End of the Year	Column 5 Net Change
Franchised	2002	859	1,062	+203
	2003	1,062	1,296	+234
	2004	1,296	2,720	+1,424
Company Owned	2002	125	145	+20
	2003	145	76	-69
	2004	76	141	+65
Total Outlets	2002	984	1,207	+223
	2003	1,207	1,372	+165
	2004	1,372	2,861	+1,489

Appendix C: Sample Item 20(2) Table – Transfers of Franchised Outlets

Transfers of Franchised Outlets
For years 2002 to 2004

Column 1 State	Column 2 Year	Column 3 Number of Transfers
NC	2002	1
	2003	0
	2004	2
SC	2002	0
	2003	0
	2004	2
Total	2002	1
	2003	0
	2004	4

Appendix D: Sample Item 20(3) Table – Status of Franchise Outlets

Status of Franchise Outlets
For years 2002 to 2004

Col. 1 State	Col .2 Year	Col. 3 Outlets at Start of Year	Col. 4 Outlets Opened	Col. 5 Terminations	Col. 6 Non-Renewals	Col. 7 Reacquired by Franchisor	Col. 8 Ceased Operations-Other Reasons	Col. 9 Outlets at End of the Year
AL	2002	10	2	1	0	0	1	10
	2003	11	5	0	1	0	0	15
	2004	15	4	1	0	1	2	15
AZ	2002	20	5	0	0	0	0	25
	2003	25	4	1	0	0	2	26
	2004	26	4	0	0	0	0	30
Totals	2002	30	7	1	0	0	1	35
	2003	36	9	1	1	0	2	41
	2004	41	8	1	0	1	2	45

Appendix E: Sample Item 20(4) Table – Status of Company-Owned Outlets

Status of Company Owned Outlets
For years 2002 to 2004

Col.1 State	Col.2 Year	Col.3 Outlets at Start of the Year	Col.4 Outlets Opened	Col.5 Outlets Reacquired From Franchisees	Col.6 Outlets Closed	Col.7 Outlets Sold to Franchisees	Col.8 Outlets at End of the Year
NY	2002	1	0	1	0	0	2
	2003	2	2	0	1	0	3
	2004	3	0	0	3	0	0
OR	2002	4	0	1	0	0	5
	2003	5	0	0	2	0	3
	2004	3	0	0	0	1	2
Totals	2002	5	0	2	0	0	7
	2003	7	2	0	3	0	6
	2004	6	0	0	3	1	2

Appendix F: Sample Item 20(5) Table – Projected New Franchised Outlets

Projected New Franchised Outlets
As of December 31, 2004

Column 1 State	Column 2 Franchise Agreements Signed But Outlet Not Opened	Column 3 Projected New Franchised Outlet in the Next Fiscal Year	Column 4 Projected New Company-Owned Outlets in the Current Fiscal Year
CO	2	3	1
NM	0	4	2
Total	2	7	3

ATTACHMENT C

NOTICE OF PROPOSED RULEMAKING

PART 436 -- DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING

SUBPART A - DEFINITIONS

Sec.

SUBPART B - OBLIGATIONS OF FRANCHISORS AND OTHER FRANCHISE SELLERS

SUBPART C - THE CONTENTS OF A DISCLOSURE DOCUMENT

SUBPART D - INSTRUCTIONS

SUBPART E - OTHER PROVISIONS

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

SUBPART A - 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.

SUBPART B - 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.

SUBPART C - 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

§ 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 this paragraph (a), 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;[1] and

(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

[1] Only laws pertaining specifically to the industry sector of the franchised business, and not 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.

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 paragraph (b) of this section, 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 paragraph, "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.

(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.[2]

(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 in paragraph (c)(1) of this section, 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

[2] 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.

in the action, the relief sought or obtained, and any conclusions of law or fact.[3] 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;[4]

(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.

(1) Disclose whether the franchisor, its parent, predecessor, a person identified in paragraph (b) of this section, 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.

---

[3] 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.

[4] 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.

(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.[5]

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

(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

[5] 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."

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 from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor's specifications. Include obligations to purchase imposed by written agreement or by the franchisor's practice.[6] 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

(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.[7] 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] 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 paragraph (e) of this section. Franchisors should not disclose fees already described in paragraph (f) of this section.

[7] Figures should be taken from the franchisor's most recent annual audited financial statement required in paragraph (u) of this section. 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.

(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 paragraph, 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.

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,[8] including leases and installment contracts, that the franchisor, its agent, or affiliates offers directly or indirectly to the franchisee.[9] 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 to this part. 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);[10]

(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;

(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.

---

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

[9] 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.

[10] Include specimen copies of the financing documents as an exhibit to paragraph (v) of this section. Cite the section and name of the document containing the financing terms and conditions.

(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

Su

(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:[11]

(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

---

[11] 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.

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;

(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.[12]

(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.

(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.

---

[12] 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.

(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: a franchisor provides the actual records of an existing outlet you are considering buying; or a franchisor provides financial performance information in paragraph (s) of this section 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,[13] or a subset of those outlets, or is a forecast of the prospective franchisee's future financial performance.[14]

(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;[15] and

(F) Characteristics of the included outlets, such as those noted in paragraph (s)(3)(i) of this section, 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

---

[13] 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.

[14] 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.

[15] 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.

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;

(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.[16]

(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 paragraph (s) of this section, 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 paragraph (s)(3)(i)-(iii) of this section; 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 paragraph, "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 to this part.

---

[16] 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 Begin-ning of Fiscal Year	(3) Outlets With Same Owner-ship 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 Transferr-ed 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 Discontin-ued 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 to this part.

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 to this part.

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 paragraph (u)(2) of this section, 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 paragraph (u)(1)(i) of this section, the franchisor may include financial statements of its affiliated company if the affiliated company's financial statements satisfy paragraph (u)(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:

(i) If this is the franchisor's:	The following financial statements included in the franchisor's disclosure document must be audited:
(A) First partial or full fiscal year selling franchises.	None.
(B) Second fiscal year selling franchises.	Balance sheet opinion as of the end of the last fiscal year.
(C) 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 paragraph (u)(1)(i) of this section.

(ii) Audited financial statements shall be prepared as soon as practicable.

(iii) Unaudited statements should be in a format that conforms as closely as possible to audited statements.

(iv) Disclose clearly and conspicuously in paragraph (u) of this section 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 paragraph (u)(1)(i) of this section; or

(B) The franchisor includes one or more years of unaudited financial statements.

(v) 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 section 436.5(a), 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.

SUBPART D - 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 section 436.5(u) 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.

SUBPART E - OTHER PROVISIONS

§ 436.9 Exemptions.

The disclosure requirements of sections 436.2 - 436.8 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 section 436.5(s), 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 section 436.5(s) 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 section 436.5(s)(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.

ATTACHMENT D

Comparison Chart: NPR and Proposed Revised Rule

NPR Proposal	Status	Revised Proposal
Section 436.1 Definitions		**Section 436.1 Definitions**
436.1(a:) Action	Revised	436.1(a): Action
436.1(b): Affiliate	Revised	436.1(b): Affiliate
436.1(c): Disclose	Revised and renumbered	436.1(d): Disclose, state, describe, and list
436.1(d): Financial performance representation	Revised and renumbered	436.1(e): Financial performance representation
436.1(e): Fiscal year	Same, but renumbered	436.1(f): Fiscal year
436.1(f): Fractional franchise	Same, but renumbered	436.1(g): Fractional franchise
436.1(g): Franchise	Revised and renumbered	436.1(h): Franchise
436.1(h): Franchise seller	Revised and renumbered	436.1(i): Franchise seller
436.1(i): Franchisee	Revised and renumbered	436.1(j): Franchisee
436.1(j): Franchisor	Revised and renumbered	436.1(k): Franchisor
436.1(k): Gag clause	Revised and renumbered	436.1(c): Confidentiality clause
436.1(l): Internet	Deleted	
436.1(m): Leased department	Revised and renumbered	436.1(l): Leased department
436.1(n): Material	Deleted	
436.1(o): Officer	Deleted	
	New	436.(m): Parent
436.1(p): Person	Revised and renumbered	436.1(n): Person
436.1(q): Plain English	Same, but renumbered	436.1(o): Plain English
436.1(r): Predecessor	Revised and renumbered	436.1(p): Predecessor
436.1(s): Principal business address	Same, but renumbered	436.1(q): Principal business address

436.1(t): Prospective franchisee	Same, but renumbered	436.1(r): Prospective franchisee
436.1(u): Required payment	Revised and renumbered	436.1(s): Required payment
436.1(v): Sale of a franchise	Revised and renumbered	436.1(t): Sale of a franchise
436.1(w): Signature	Revised and renumbered	436.1(u): Signature
436.1(x): Trademark	Same, but renumbered	436.1(v): Trademark
436.1(y): Written	Revised and renumbered	436.1(w): Written
Section 436.2 The obligation to furnish documents		**436.2 Obligation to furnish documents**
436.2: Domestic application	Same	436.2: Domestic application
436.2(a)(1): Fourteen-day trigger	Revised and renumbered	436.2(a): Fourteen-day trigger
436.2(a)(2): Five-day trigger	Revised and renumbered	436.2(b): Seven-day trigger
436.2(b): Delivery	Revised and renumbered	436.2(c): Delivery
436.2(c): Liability	Revised and renumbered	436.2(d): Liability
Section 436.3 Cover page		**Section 436.3 Cover page**
436.3(a)-(d): Title, background, trademark, and description	Same	436.3(a)-(d): Title, background, trademark, and description
436.3(e): Reference to Items 5 and 7	Revised and renumbered	436.3(e)(1): Reference to Items 5 and 7.
436.3(f): Issuance date	Same, but renumbered	436.3(e)(5): Issuance date
436.3(g)(1): General background information	Revised and renumbered	436.3(e)(2): General background information
436.3(g)(2): Electronic disclosure	Revised and renumbered	436.3(f): Alternative formats
436.3(g)(3): Sources of information	Revised and renumbered	436.3(e)(3): Sources of information
436.3(g)(4): Information about the contract	Same, but renumbered	436.3(e)(4): Information about the contract
436.3(g)(5): Federal Trade Commission	Deleted	

436.3(h): Inclusion of state disclosures	Revised and renumbered	436.3(g): Inclusion of state disclosures
Section 436.4 Table of Contents		**Section 436.4 Table of Contents**
436.4 at 1: The Franchisor, Parent, Predecessors, and Affiliates	Revised	436.4 at 1: The Franchisor and any Parent, Predecessors, and Affiliates
436.4 at 2-4: Business Experience, Litigation, Bankruptcy	Same	436.4 at 2-4: Business Experience, Litigation, Bankruptcy
436.4 at 5: Initial Franchisee Fee	Revised	436.4 at 5: Initial Fees Paid to the Franchisor
436.4 at 6-22:	Same	436.4 at 6-22:
436.4 at 23: Receipt	Revised	436.4 at 23: Receipts
Section 436.5 Disclosure items		**Section 436.5 Disclosure items.**
Section 436.5(a) Item 1: The Franchisor, its Parents, Predecessors, and Affiliates		**Section 436.5(a) Item 1: The Franchisor and any Parent, Predecessors, and Affiliates**
436.5(a)(1): Background on franchisor, parent, and affiliates	Revised	436.5(a)(1): Background on franchisor and any parent and affiliates
436.5(a)(2): Background on predecessors	Revised	436.5(a)(2): Background on predecessors
436.5(a)(3): Franchisor's name	Same	436.5(a)(3): Franchisor's name
436.5(a)(4): Principal business address	Revised	436.5(a)(4): Principal business address
436.5(a)(5): Type of business organization	Same	436.5(a)(5): Type of business organization
436.5(a)(6)(i)-(v): Nature of the franchisor's business	Revised	436.5(a)(6)(i)-(v): Nature of the franchisor's business
	New	436.5(a)(6)(vi): Competition from entity in which company officer owns an interest

436.5(a)(7): Prior business experience	Revised	436.5(a)(7): Prior business experience
436.5(a) Footnote 1: Industry regulations	Deleted (to be included in Compliance Guides)	
Section 436.5(b) Item 2: Business Experience	Revised	**Section 436.5(b) Item 2: Business Experience**
Section 436.5(c) Item 3: Litigation		**Section 436.5(c) Item 3: Litigation**
436.5(c)(1): Introduction	Revised	436.5(c)(1): Introduction
436.5(c)(1)(i): Pending suits	Revised	436.5(c)(1)(i): Pending suits
436.5(c)(1)(ii): Franchise relationship suits	Revised	436.5(c)(1)(ii): Franchise relationship suits
436.5(c)(1)(iii): Convictions, prior civil actions	Revised	436.4(c)(1)(iii): Convictions, prior civil actions
436.5(c)(1)(iv): Injunctive actions	Revised and renumbered	436.5(c)(2): Injunctive actions
436.5(c)(2): Description of litigation	Revised and renumbered	436.5(c)(3): Description of litigation
436.5 Footnote 2: Favorable settlements, dismissed actions	Deleted (to be included in Compliance Guides)	
436.5 Footnote 3: Summary opinion	Revised and renumbered	436.5 Footnote 1: Summary opinion
436.5 Footnote 4: Confidential settlements	Revised and renumbered	436.5 Footnote 2: Confidential settlements
Section 436.5(d) Item 4: Bankruptcy		**Section 436.5(d) Item 4: Banktruptcy**
436.5(d)(1): Basic instruction	Revised	436.5(d)(1): Basic instruction
436.5(d)(1)(i)-(iii): Basic disclosure	Same	436.5(d)(1)(i)-(iii): Basic disclosure

436.5(d)(2): Description of matters	Same	436.5(d)(2): Description of matters
436.5(d)(3): Foreign bankruptcies	Same	436.5(d)(3): Foreign bankruptcies
Section 436.5(e) Item 5: Initial Franchise Fee	Revised	**Section 436.5(e) Item 5: Initial Fees Paid to the Franchisor**
Section 436.5(f) Item 6: Recurring or Occasional Fees	Revised	**Section 436.5(f) Item 6: Other Fees**
436.5(f): Basic instruction	Revised	436.5(f): Basic instruction
436.5(f)(1): Type of fee	Same	436.5(f)(1): Type of fee
436.5(f)(2): Amount of the fee	Revised	436.5(f)(2): Amount of the fee
436.5(f)(3): Due date	Same	436.5(f)(3): Due date
436.5(f)(4): Remarks	Revised	436.5(f)(4): Remarks
	New	436.5(f)(4)(iv): If fees are uniformly imposed
436.5(f) Footnote 5: Fee increases	Same, but renumbered	436.5(f) Footnote 3: Fee increases
436.5(g) Item 7: Estimated Initial Investment		**436.5(g) Item 7: Estimated Initial Investment**
436.5(g): Basic instruction	Revised	436.5(g): Basic instruction
436.5(g)(1)(i)-(vii): Table column 1	Same, but renumbered	436.5(g)(1)(i)-(ii): Table column 1
436.5(g)(1)(viii): Table column 1 (other payments)	Revised and renumbered	436.5(g)(1)(iii): Table column 1 (other payments)
436.5(g)(2)-(5): Table columns 2-5	Same	436.5(g)(2)-(5): Table columns 2-5
436.5(g)(6)-(7): Total and footnotes	Same	436.5(g)(6)-(7): Total and footnotes
436.5(h) Item 8: Restrictions on Sources of Products and Services		**436.5(h) Item 8: Restrictions on Sources of Products and Services**

436.5(h)(1): Basic instructions	Revised	436.5(h): Basic instructions
436.5(h)(2): Approved suppliers	Revised	436.5(h)(2): Approved suppliers
	New	436.5(h)(3): Supplier in which officer has an interest
436.5(h)(3): Alternative suppliers	Revised and renumbered	436.5(h)(4): Alternative suppliers
436.5(h)(4)-(10): Other disclosures	Same, but renumbered	436.5(h)(5)-(11): Other disclosures
436.5(h) Footnote 6: Reasons for requirement	Same, but renumbered	436.5(h) Footnote 4: Reasons for requirement
436.5(h) Footnote 7: Audited figures	Same, but renumbered	436.5(h) Footnote 5: Audited figures
436.5(i) Item 9: Franchisee's Obligations	Revised	**436.5(i) Item 9: Franchisee's Obligations**
436.5(j) Item 10: Financing	Same	**436.5(j) Item 10: Financing**
436.5(j) Footnote 8: Payments due within 90 days	Deleted (to be included in Compliance Guides)	
436.5(j) Footnote 9: Indirect offers	Same, but renumbered	436.5(j) Footnote 6: Indirect offers
436.5(j) Footnote 10: Copies of financing documents	Same, but renumbered	436.5(j) Footnote 7: Copies of financing documents
436.5(k) Item 11: Franchisor's Assistance, Advertising, Computer Systems, and Training		**436.5(k) Item 11: Franchisor's Assistance, Advertising, Computer Systems, and Training**
436.5(k)(1)-(4): Pre-opening and ongoing assistance, advertising	Same	436.5(k)(1)-(4): Pre-opening and ongoing assistance, advertising
436.5(k)(5): Electronic equipment	Revised	436.5(k)(5): Electronic equipment

436.5(k)(6)-(7): Operating manual, training	Same	436.5(k)(5): Operating manual, training
Section 436.5(l) Item 12: Territory		**Section 436.5(l) Item 12: Territory**
436.5(l)(1)(i): Minimum area	Same, but renumbered	436.5(l)(2): Minimum area
436.5(l)(1)(ii): Specific location	Same, but renumbered	436.5(l)(1): Specific location
436.5(l)(1)(iii): Relocation	Same, but renumbered	436.5(l)(3): Relocation
436.5(l)(1)(iv): Other franchisees	Deleted	
436.5(l)(1)(v): Franchisor-owned outlets and other channels of distribution	Revised and renumbered	436.5(l)(6)(i)(A): Franchisor-other channels of distribution under principal trademark
436.5(l)(1)(vi): Other channels of distribution under different mark	Revised and renumbered	436.5(l)(6)(i)(B): Franchisor - other channels of distribution under different mark
436.5(l)(1)(vii): Restrictions on franchisor outlets within territory	Deleted	
436.5(l)(1)(viii): Restrictions on franchisee outside territory	Revised and renumbered	436.5(l)(6)(ii): Restrictions on franchisee outside territory
436.5(l)(1)(ix): Restrictions on franchisor inside territory	Revised and renumbered	436.5(l)(6)(i): Restrictions on franchisor inside territory
436.5(l)(1)(x): Right of first refusal	Revised and renumbered	436.5(l)(4): Right of first refusal
436.5(l)(2)(i)(A)-(B): Exclusivity	Revised and renumbered	436.5(l)(5): Exclusivity
436.5(l)(2)(ii): No exclusive	Revised and renumbered	436.5(l)(5)(i): No exclusive
436.5(l)(3): Present plans	Revised and renumbered	436.5(1)(6)(iii): Present plans
Section 436.5(m) Item 13: Trademark		**Section 436.5(l) Item 13: Trademark**

436.5(m)(1): Principal trademarks	Same	436.5(m)(1): Principal trademarks
436.5(m)(2): Registration	Revised	436.5(m)(2): Registrations
		436.5(m)(3): Applications
		436.5(m)(4): Unregistered tradermarks
436.5(m)(3)-(6): Determinations, pending litigation, current agreements, obligations to defend	Same, but renumbered	436.5(m)(5)-(8): Determinations, pending litigation, current agreements, obligations to defend
436.5(m)(7): Superior rights	Revised and renumbered	436.5(m)(9): Superior rights
436.5(m) Footnote 12: Summary opinion	Revised and renumbered	436.5(m) Footnote 8: Summary opinion
Section 436.5(n) Item 14: Patents		**Section 436.5(n) Item 14: Patents**
436.5(n)(1)-(2): Description of patents and copyrights	Same	436.5(n)(1)-(2): Description of patents and copyrights
436.5(n)(3): Court actions	Revised	436.5(n)(3): Court actions
436.5(n)(4)-(7): Agreements, obligations, other proprietary information	Same	436.5(n)(4)-(7): Agreements, obligations, other proprietary information
436.5(n) Footnote 12: Opinion of counsel	Revised and renumbered	436.5(n) Footnote 9: Opinion of counsel
Section 436.5(o) Item 15: Obligations to participate	Same	**Section 436.5(o) Item 15: Obligations to participate**
Section 436.5(p) Item 16: Restrictions on what franchise may sell	Same	**Section 436.5(p) Item 16: Restrictions on what franchise may sell**

Section 436.5(q) Item 17: Renewal, Termination		**Section 436.5(q) Item 17: Renewal, Termination**
436.5(q): Basic instruction	Same, but renumbered	436.5(q): Basic instruction
		436.5(q)(1): Summarize each contract provision
		436.5(q)(2): Assistance as matter of policy
	New	436.5(q)(3): Explain term "renewal"
Section 436.5(r) Item 18: Public Figures	Same	**Section 436.5(r) Item 18: Public Figures**
Section 436.5(s) Item 19: Financial performance representations		**Section 436.5(s) Item 19: Financial performance representations**
436.5(s)(1): First preamble	Revised	436.5(s)(1): First preamble
436.5(s)(2): Second preamble	Revised	436.5(s)(2): Second preamble
436.5(s)(3): Basic instructions	Same	436.5(s)(3): Basic instructions
436.5(s)(3)(ii): Past performance	Same	436.5(s)(3)(ii): Past performance
436.5(s)(3)(iii): Forecasts	Same	436.5(s)(3)(iii): Forecasts
436.5(s)(3)(iv)-(v): Admonition and substantiation	Same	436.5(s)(3)(iv)-(v): Admonition and substantiation
436.5(s)(4): Actual outlets	Same	436.5(s)(4): Actual outlets
436.5(s)(5): Supplemental information	Same	436.5(s)(5): Supplemental information
436.5(s) Footnote 13: GAAP	Deleted	
436.5(s) Footnotes 14-16: Reasonable basis, written substantiation	Deleted (to be revised and placed in Compliance Guides)	
Section 436.5(t) Item 20: Outlets and Franchisee Information		**Section 436.5(t) Item 20: Outlets and Franchisee Information**

436.5(t)(1): Franchised Outlets Summary	Revised	436.5(t)(1): Systemwide Outlet Summary
	New	436.5(t)(2)(i): Transfers of Franchised Outlets
	New	436.5(t)(2)(ii): Franchised outlets
436.5(t)(2): Franchisor-Owned Outlets Summary	Revised and renumbered	436.5(t)(2)(iii): Company-owned outlets
436.5(t)(3): Projected openings	Revised	436.5(t)(3): Projected new franchised outlets
	New	436.5(t)(4): Sales of exiting units
436.5(t)(4): Names and addresses of current franchisees	Same, but renumbered	436.5(t)(5): Names and addresses
436.5(t)(5): Names and addresses of former franchisees	Same, but renumbered	436.5(t)(6): Names and addresses of former franchisees
436.5(t)(6): Gag clauses	Revised and renumbered	436.5(t)(7): Confidentiality clauses
436.5(t)(7): Trademark-specific organizations	Revised and renumbered	436.5(t)(8): Trademark-specific organizations
	New	436.5(t)(8)(ii): Disclaimer
Section 436.5(u) Item 21: Financial Statements		**Section 436.6(u) Item 21: Financial Statements**
436.5(u)(1): Basic disclosure	Revised	436.5(u)(1): Basic disclosure
436.5(u)(1)(i): Financial statements	Same	436.5(u)(1)(i): Financial statements
436.5(u)(1)(ii): Affiliated company statements	Revised	436.5(u)(1)(ii): Affiliated company statements
436.5(u)(1)(iii): Consolidated and separate statements	Revised	436.5(u)(1)(iii): Consolidated and separate statements
436.5(u)(2): Phase-in	Same	436.5(u)(2): Phase-in
Section 436.5(v) Item 22: Contracts	Same	**Section 436.5(v) Item 22: Contracts**

Section 436.5(w) Item 23: Receipt		**Section 436.5(w) Item 23: Receipt**
436.5(w)(1): Basic instruction	Revised and renumbered	436.5(w): Basic instruction
436.5(w)(1)(i): Text	Revised and renumbered	436.5(w)(1): Text
436.5(w)(1)(ii): Disclosure of names	Revised and renumbered	436.5(w)(2): Disclosure of names
436.5(w)(1)(iii)-(viii): Various statements	Same, but renumbered	436.5(w)(3)-(8): Various statements
436.5(w)(2): Timing for receipt	Deleted	
436.5(w)(3): Recordkeeping	Same, but renumbered	436.6(h): Receipt recordkeeping
Section 436.6 Instructions		**Section 436.6 Instructions**
436.6(a): Plain English	Same	436.6(a): Plain English
	New	436.6(a): Capable of preservation
436.6(b): Responses	Same	436.6(b): Responses
436.6(c): No additional materials	Same	436.6(c): No additional materials
	New	436.6(c): Navigational tools
436.6(c): Multi-State disclosures	Same, but renumbered	436.6(d): Multi-State disclosures
436.6(d): Subfranchisors	Revised and renumbered	436.6(e): Subfranchisors
	New	436.6(f): Format and prerequisite disclosure
	New	436.6(g): Disclosure document recordkeeping
	Same, but renumbered	436.6(h): Receipt recordkeeping
Section 436.7 Instructions for electronic disclosure documents	Deleted	
Section 436.8 Instructions For Updating		**Section 436.7 Instructions for Updating**
436.8(a): Annual updates	Revised and renumbered	436.7(a): Annual updates
436.8(b): Quarterly updates	Same, but renumbered	436.7(b): Quarterly updates

	New	436.7(c): Relationship between annual and quarterly updates
436.8(c): Material changes	Revised and renumbered	436.7(d): Material changes
436.8(d): Update of audited information	Same, but renumbered	436.7(e): Update of audited information
Section 436.9 Exemptions		**Section 436.8 Exemptions**
436.9(a): $500 Minimum payment exemption	Revised and renumbered	436.8(a)(1): $500 Minimum payment exemption
436.9(b): Fractional franchise exemption	Same, but renumbered	436.8(a)(2): Fractional franchise exemption
436.9(c): Leased department exemption	Same, but renumbered	436.8(a)(3): Leased department exemption
436.9(d): PMPA exemption	Same, but renumbered	436.8(a)(4): PMPA exemption
436.9(e)(1): Large initial investment exemption	Revised and renumbered	436.8(a)(5)(i): Large initial investment exemption
436.9(e)(2): Large investor exemption	Revised and renumbered	436.8(a)(5)(ii): Large investor exemption
436.9(e)(2): Inflation adjustment	Revised and renumbered	436.8(b): Inflation adjustment
436.9(f): Owner exemption	Revised and renumbered	436.8(a)(6): Owner exemption
436.9(g): Oral agreements	Same, but renumbered	436.8(a)(7): Oral agreements
Section 436.10 Additional Prohibitions		**Section 436.9 Additional Prohibitions**
436.10 (a): Contradictory statements	Same, but renumbered	436.9(a): Contradictory statements
436.10(b): Refunds	Same, but renumbered	436.9(j): Refunds
436.10(c): Written substantiation for performance claims	Same, but renumbered	436.9(d): Written substantiation for performance claims
436.10(d): Financial Information	Revised and renumbered	436.9(c): Financial Information
436.10(e): Disclaimers	Revised and renumbered	436.9(i): Disclaimers
436.10(f): Shills	Same, but renumbered	436.9(b): Shills

	New	436.9(e): Requests for early disclosure
	New	436.9(f): Requests for disclosure by transferee
	New	436.9(g): Requests for updated disclosures
	New	436.9(h): Materially altering contract terms without notice
Section 436.11 Other Laws, Rules, Orders.	Same, but renumbered	**436.10 Other Laws, Rules, Orders**
436.11(a): Non-approval	Same, but renumbered	436.10(a): Non-approval
436.11(b): Outstanding Orders	Same, but renumbered	436.10(b): Outstanding Orders
436.11(c): Preemption	Same, but renumbered	436.10(c): Preemption
Section 436.12 Severability	Same, but renumbered	**436.11 Severability**