December 21, 1999

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

Re: 16 CFR Part 436 - - Franchise Rule Comment

Dear Sir:

Set forth herein are the comments of the National Franchise Council ("NFC") addressing the Notice of Proposed Rulemaking ("NPR") released by the Federal Trade Commission ("FTC" or the "Commission") on October 22, 1999.

SYLLABUS

REMAINDER OF PAGE INTENTIONALLY LEFT BLANK

I. BACKGROUND OF THE NFC

The National Franchise Council is an organization comprised of many of the nation's foremost franchisors, all of whom possess exemplary reputations and histories of regulatory compliance.

The NFC's members and their brands include as of this date: Tricon Global Restaurants, Inc. (Pizza Hut/Taco Bell/KFC); Bass Hotels & Resorts, Inc. (Holiday Inn, Inter-Continental Hotels); AFC Enterprises, Inc. (Churchs Chicken/Cinnabon/Popeye's Chicken & Biscuit/Seattle Coffee Company); Cendant Corporation (Ramada/Days Inn/Super 8 Motels/Howard Johnson/Jackson Hewitt Tax Service/Travelodge/Avis/Century 21 Real Estate/Coldwell Banker Real Estate/ERA Real Estate); Hilton Hotels Corporation; Choice Hotels International (Comfort Inn/Clarion Hotel/Sleep Inn/Quality Inn/Rodeway Inn/Econo Lodge/MainStay Suites); Promus Hotel Corporation (Hampton Inn/Embassy Suites/Homewood Suites/Doubletree Hotels); Pearle Vision, Inc.; Marriott International; Meineke Discount Muffler Shops, Inc.; ServiceMaster Residential/Commercial Services L.P. (TruGreen - ChemLawn/Terminix/Merry Maids/ServiceMaster/AmeriSpec/Furniture Medic); Snelling & Snelling, Inc. (Snelling Personnel Services); Triarc Restaurant Group (Arby's/T.J. Cinnamons/Snapple); 7-Eleven, Inc.; Midas International; and, Starwood Hotels & Resorts Worldwide, Inc. (Sheraton Hotels/Westin Hotels).

The NFC is a staunch advocate of full and complete pre-sale disclosure in the franchise sales arena. Indeed, the NFC's alternative law enforcement program - - an effort to foster compliance with our nation's franchise disclosure laws through compliance training, monitoring and mediation - - has been adopted on a trial basis by the FTC and the State of New York; other states have referred franchise disclosure law violators to the NFC for compliance retraining, monitoring and mediation and are considering formal adoption of the NFC program.

Although the NFC is little more than one year old, over a dozen matters have been referred to the NFC (or shortly will be) by the FTC, New York and other franchise-regulating states and our alternative enforcement program has already had a significant impact in the franchise community.

II. FORMAT OF THIS COMMENT LETTER

For ease of review, this comment letter is composed of two segments.

The first segment - - entitled "General Comments" - - embraces certain issues and subjects addressed in the NPR which affect more than one provision of the FTC Franchise Rule (as the NPR proposes to revise same) or are keyed to disclosure generally. For example, the issue of whether a franchisor should be required to disclose certain information regarding its corporate "parent" in that franchisor's disclosure document spans numerous "Disclosure Items" of the proposed revised Rule. Accordingly, we feel it most logical, and of benefit to the Commission, to address this subject thematically first and, thereafter, within the NFC's provision-by-provision comments.

The second segment of this letter - - entitled "Section-by-Section Comments" - - comments upon the proposed revisions to the FTC Franchise Rule on a section-by-section basis and incorporates the above-referenced "general" comments to the particular provisions of the FTC Franchise Rule under review.

III. AN EXPRESSION OF APPRECIATION

Before providing our comments, the NFC wishes to acknowledge, and express its appreciation for, the diligence, competence and intelligence devoted by the FTC and its staff in promulgating its NPR.

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. The NFC strongly favors the many significant and salutary changes proposed by the Commission, including the substitution of "UFOC plus" for the Rule disclosure format; clarification that the Rule applies only to domestic transactions; elimination of the "first personal meeting" disclosure trigger; provision for the electronic delivery of disclosure documents; and, creation of a "sophisticated investor" exemption from disclosure.

Although we suggest below numerous modifications for the FTC's consideration, the NFC strongly supports the Rule revision proposed in the NPR and commends the FTC and its staff's farsightedness and grasp of the plethora of demographic, economic and technological evolutions which have so impacted the franchise marketplace.

IV. GENERAL COMMENTS

In this section of the NFC's comment letter, we shall address by subject certain issues which affect more than one provision of the proposed revised FTC Franchise Rule and/or address the disclosure process generally.

A. "De Facto" Officers

While the NFC agrees with the FTC that all officers, directors and other individuals retained by a franchisor who will possess significant managerial responsibilities for marketing and/or servicing franchises should be the subject of disclosure in that franchisor's disclosure document, we respectfully disagree with the terminology the Commission proposes to utilize for this last category of management personnel - - "de facto officers" (see NPR, §4[o]).

Our concern with this terminology is based on the fact that many states have statutes that impose certain duties, responsibilities and liabilities upon "officers" and afford to corporations the power to appoint and discharge them. This long-established paradigm could be upset were the FTC to promulgate a new classification of "officer" - - the "de facto officer".[1]

Further, various provisions of federal law similarly impose certain duties and liabilities upon a corporation's "officers".[2]

We do not believe that the FTC wishes to inadvertently confer/impose certain rights, duties and liabilities upon individuals who are not technically "officers" of the subject franchisor corporation but who may fall within the NPR's definition of a "de facto officer". For that reason, we propose that the revised Rule track the UFOC Guidelines for Item 2 by eliminating the last sentence of §436.1(o) (which defines a "de facto officer" in the same manner as an "officer" is defined in the preceding sentence).

B. Disclosure Concerning a Franchisor's "Predecessors"

Proposed Sections 436.5(a)(7); 436.5(b); 436.5(c); and, 436.5(d) of the revised FTC Franchise Rule would require a franchisor to make pertinent disclosures regarding inter alia its "predecessor".

---

[1] See, e.g., Section 715 of the New York Business Corporation Law provides that only a corporation's board of directors may elect or appoint an officer and imposes upon each officer the obligation to "...perform his duties as an officer in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances"; Section 716 empowers the corporation's board of directors - - and, indeed, the Attorney General of New York - - to bring an action seeking removal of any given corporate officer; Section 720 subjects corporate officers to certain statutorily imposed liabilities; and, the indemnification of corporate officers specifically ordained by Section 722 of the New York Business Corporation Law may be deemed to extend to "de facto officers" were the FTC Franchise Rule to adopt such nomenclature. New York's corporate law is cited by way of example only - - virtually every other state has a similar statute defining the term "officer" and/or imposing certain duties, responsibilities and liabilities upon corporate "officers".

[2] Without limitation, these include the Internal Revenue Code (26 USCA §1 et seq.) (see §7201 and U.S. v. Genser, 582 F.2d 292 [CANJ 1978] cert. denied 444 U.S. 928, 100 S.Ct. 269, 62 L.Ed.2d 185 [1979]); the United States Civil Rights Law (42 USCA §§1981 et seq. and Moffett v. Gene B. Glick Co., Inc., 604 F.Supp. 229 [DC Ind. 1984] decided thereunder); and, the Americans With Disabilities Act (42 USCA §§12101 et seq. - - see inter alia Hendrix v. Fleming Companies, 650 F.Supp. 301 [W.D.Okl. 1986] for the proposition that "officers" may bear individual liability for violations of the ADA).

The difficulty here lies in the NPR's definition of this term which, as set forth at Section 436.1(r) of the proposed revised FTC Franchise Rule, would include "...a person...from whom the franchisor obtained a license to use the trademark or trade secrets in the franchise operation".

As the Commission itself notes in Section (C)(4)(r) of the NPR, this inclusion of "any person from whom the franchisor obtained the right to use the trademark or trade secrets associated with the franchise system" is new to franchise law, constituting an enhancement to the definition of the term "predecessor" set forth in the Uniform Franchise Offering Circular Guidelines (as adopted by the North American Securities Administrators Association ["NASAA"] on April 25, 1993 and approved by the FTC as an alternative to the FTC Franchise Rule's disclosure format on December 30, 1993) (hereafter the "UFOC Guidelines").

The difficulty here is that the corporate "parents" or "grandparents" of many large franchisors, especially those with an international presence, frequently use otherwise dormant corporate intermediaries to funnel their names, marks and know-how down to the true franchisor. They use such intermediary corporations for this purpose to address a number of issues - - foreign ownership requirements; a myriad of corporate tax objectives; insulation from subsidiary liabilities; the desire to engage in securitization activities (through which a franchisor monetizes its franchisee revenue stream through public offerings or private placements); and/or, to isolate intellectual property in a "bankruptcy remote" setting.

Disclosing information regarding these dormant intermediary corporations - - which would be required under Items 2 and 3 of the proposed revised FTC Franchise Rule §§436.5[b] and [c] - - would fill a franchisor's disclosure document with irrelevant, if not misleading, information. As noted above, these dormant intermediary corporations - - which technically serve as the "grantors" of the franchisor's name, marks and know-how - - are never involved in the solicitation of franchisees; the sale of franchises; or, the administration of the subject franchise network. (Disclosure Item 4 of the revised FTC Franchise Rule - - §436.5[d] - - would also require disclosure regarding such a "predecessor", but here the NFC submits that such disclosure is completely warranted.)

Accordingly, the NFC respectfully suggests below (under the heading "Section-by-Section Comments") that disclosure regarding such a "predecessor" be limited to reciting the fact that the franchisor received from such predecessor the name, mark and know-how to be utilized by the subject franchise network and its franchisees under a contract dated (fill in date) which will expire on (fill in date of expiration and any rights of renewal the franchisor possesses).

Finally, with regard to disclosure of other "predecessors" (that is, "a person from whom the franchisor acquired, directly or indirectly, the major portion of the franchisor's assets..."), the NFC strongly recommends limiting such disclosure to the period of time before the franchisor acquired the subject assets from such "predecessor". This would bring the revised FTC Franchise Rule in line with the UFOC Guidelines (see

Instruction [1][F]) and would eliminate the need for the subject franchisor to make irrelevant and misleading disclosures regarding the predecessor's franchising activities; management personnel (officers, directors and their prior employment histories); and, litigation history following the date that the franchisor acquired from its "predecessor" the subject assets. Such post-acquisition information regarding such a "predecessor" will be of no probative value whatsoever to prospective franchisees and will only unnecessarily lengthen the subject franchisor's disclosure document. Further, franchisors may be unable to procure any such post-acquisition information from their "predecessors", let alone accurate information furnished in a timely manner. As before, however, we limit our comment in this regard to Disclosure Items 1, 2 and 3 (§§436.5[a], [b] and [c]) - - the NFC does believe that requiring information regarding a predecessor's post-disposition bankruptcy, as required by Disclosure Item 4 (§436.5[d]) most likely will prove material to a prospective franchisee's investment decision.

C. Disclosure Regarding a Franchisor's Corporate "Parent"

1. Unintended Imposition of Duties and Liabilities Upon Parents

The NFC respectfully submits that much of the disclosure regarding a franchisor's corporate "parent" - - which would be required under Disclosure Items 1 - 3 of the proposed revised Rule (§436.5[a] - [c]) will prove unnecessary; burdensome; and, quite misleading to prospective franchisees.

Instead, to achieve the Commission's goal of informing prospective franchisees as to whether the franchisor's "parent" may directly compete with such franchisees by offering franchises under a different trademark or acquiring a competing franchise system, and further to inform such prospective franchisees of such a franchisor parent's litigation history, the NFC respectfully suggests that the Commission consider limiting disclosure regarding a franchisor's corporate parent in the same manner as it treats disclosure concerning "affiliates" - - that is, by requiring disclosure only if such parent "is offering franchises in any line of business or is providing products or services to the franchisees of the franchisor" (the quoted language is taken from the UFOC Guidelines, Item 1, Item 1 Instructions, subdivision [v]).

One of the principal reasons the NFC opposes disclosure of a franchisor's parent which is not itself franchising and will not be servicing its subsidiary franchisor's franchisees is the confusion that will be engendered in the minds of prospective franchisees as to who, ultimately, is responsible and liable for the franchisor's performance under its franchise agreements and for fulfilling the franchisor's disclosure obligations. The NFC is concerned that a franchisor's disclosure of the name and address of its corporate parent; its business experience; its litigation history; and, that corporate parent's financial statements (as the NPR would require under Disclosure Item 21 - - see §436.5[u][3][C]) of the proposed revised Rule), then a prospective franchisee - - and a judge and/or jury - - could reasonably believe that said corporate parent is responsible for fulfilling the franchisor's obligations under the subject franchise agreement and/or responding in damages for any breach of the franchisor's contractual or disclosure obligations. We submit that such a result, though inequitable, is a probable consequence if the contemplated mandated disclosures regarding a franchisor's corporate parent are ultimately required and such a result would impede legitimate franchising activity.

A franchisor's corporate parent is, in fact, not responsible for its subsidiary's disclosure or contractual breaches. Under corporate law, unless the corporate formalities and distinctions between a corporation and its parent are not observed (through the two entities having distinct meetings of shareholders and directors; distinct bank accounts; distinct books and records; distinct identities; and, taking other steps to avoid confusion between the two corporate entities), then the performance and financial obligations of a subsidiary corporation may not be imputed to its corporate parent.

The fundamental insularity of a corporation's parent from the duties, obligations and debts of its subsidiaries has been eloquently stated: "It is now accepted as one of the first principles of American law that those who own shares in corporations, whether such shareholders are individuals or are themselves corporations, normally are not liable for the debts of their corporations. It is further accepted as perfectly legal to incorporate for the express purpose of limiting the liability of the corporation's owners". Presser, Piercing the Corporate Veil, West Group, 1999, at pages 1-1 - 1-2.[3]

The U.S. Supreme Court reiterated this principle just last year in United States v. Bestfoods, 524 U.S.51, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998) when, in determining whether a corporate parent should be liable for its subsidiary's environmental law violations under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), the Court held that: "A parent corporation that actively participated in, and exercised control over, the operations of a subsidiary may not, without more, be held derivatively liable as an operator of a polluting facility owned or operated by the subsidiary... (I)t is hornbook law that the exercise of the "control" which stock ownership gives to the stockholders...will not create liability beyond the assets of the subsidiary."

And this is so, held the Court, even when there are common directors and officers of both the parent and subsidiary corporations.

---

[3] Under the Revised Model Business Corporation Act, §6.22(b): "Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct". As otherwise stated by the U.S. Supreme Court in the landmark case of Anderson v. Abbott, 321 U.S. 349, 64 S.Ct. 531 (1944): "Normally, the corporation is an insulator from liability on claims of creditors... Limited liability is the rule not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital are attracted" (at 537 - 538).

However, the insulation of a corporate parent from the debts, obligations and liabilities of its subsidiary may be breached - - and the corporate veil pierced - - upon the occurrence of certain events. Key among them is the holding out by an entity that it is personally liable for the debts of the subject subsidiary corporation.[4]

Or, as bluntly stated in the foremost treatise on the subject of piercing the corporate veil:

> There seem to be a number of readily available justifications for piercing the veil in the case of parent and subsidiary corporations. **Agency arguments, as we have seen, are old favorites of those inclined to pierce the veil... The parent may wittingly or unwittingly have led a plaintiff to believe that it stands behind or considers itself liable for the obligations of its subsidiary, and a creditor who acts to his detriment in reliance on those representations may recover, not only by use of the agency theory, but also on grounds of estoppel, from the parent** (emphasis added). Presser, Piercing the Corporate Veil, Ibid. at 1-53.

This is precisely the NFC's concern: that a franchisor's corporate parent - - compelled to disclose in the franchisor's disclosure document much information regarding itself; its officers and directors; its litigation history; and, most critically, its financial statements - - may later be judicially declared to have held itself out as the guarantor of its subsidiary franchisor's obligations and/or liabilities, whether under principal/agency law, "piercing the corporate veil" theories or various doctrines imposing vicarious liabilities upon a corporation's parent.

The importance of this issue was apparent in a recent case involving Union Carbide Marble Care, Inc., a wholly-owned subsidiary of the Union Carbide Corporation. In Union Carbide Marble Care's franchise disclosure document and franchise agreement, it was repeatedly emphasized that the Union Carbide Corporation did not stand behind its subsidiary's obligations and/or liabilities. But Union Carbide Marble Care, Inc. was required by the New York Attorney General to set forth the financial statements of its corporate parent, Union Carbide Corporation, and to make much disclosure regarding said corporate parent. The result? In a franchisee-initiated lawsuit, the trial court held that it could conclusively be presumed that the Union Carbide Corporation was liable for the acts, errors and omissions of its subsidiary, Union Carbide Marble Care, Inc. A.J. Temple Marble & Tile Co., Inc. v. Union Carbide Marble Care, Inc. et al., 162 Misc.2d 941, 618 N.Y.S.2d 155 (1994). On appeal to New York's intermediary appellate court, this decision was summarily

---

[4] See Associated Vendors, Inc. v. Oakland Meat Co., 26 Cal. Rptr. 806 (1962) as cited and followed in Trans-World International, Inc. v. Smith-Hemion Products, Inc., 972 F.Supp. 1275 (CD Cal. 1997).

affirmed (214 A.D.2d 473, 625 N.Y.S.2d 904 [1995]). It took New York's highest court - - the Court of Appeals - - to hold to the contrary (87 N.Y.S.2d 574, 640 N.Y.S.2d 849 [1996]).

This case does not stand in a vacuum. To the contrary, the cases are legion in which a franchisor's corporate parent was held to be directly or vicariously liable for the acts, errors and/or omissions of its subsidiary franchisee corporation, with many such cases revolving around whether the subject plaintiff (almost always a creditor or customer) was led to believe that said parent would be so responsible.

Were the FTC Franchise Rule revised to require franchisors to disclose so much information regarding their corporate parents, it can be expected that in every franchisee-initiated action or proceeding, the franchisee will claim to have relied on such disclosure and to have formed a belief therefrom that the franchisor's corporate parent was liable for the obligations and liabilities of the franchisor itself. And it can also be expected that many courts will deem said corporate parent to be estopped from asserting otherwise, given the number of times the corporate parent's name, background and other information will appear in the subject franchisor's disclosure document.

For this reason, the NFC respectfully submits that disclosure of a franchisor's corporate parent be limited to the circumstances in which that parent offers franchises in any line of business or will be providing products or services to the franchisees of the subject franchisor, in accord with the UFOC Guidelines cited above.

However, if the FTC determines to proceed with the proposal requirement that a franchisor set forth in its disclosure document the information regarding its corporate parent as currently envisaged in the NPR (including the franchisor parent's financial statements), then we believe it is imperative in the interest of full disclosure to prospective franchisees that certain cautionary language be mandated, so as to void franchisee confusion as to which entity - - the franchisor or its parent - - truly is responsible and liable for the franchisor's duties and obligations:

> IMPORTANT NOTE: Appearing in this document is certain information regarding, and the audited financial statements of, our corporate parent (FILL IN NAME). The Federal Trade Commission Franchise Rule requires the dissemination of this information and our parent's financial statements. It is vital that you understand, however, that (name of franchisor's corporate parent) will not be your franchisor; does not in any fashion, directly or indirectly, guarantee, stand behind or bear responsibility for the performance (or non-performance) of your franchisor; and, may not be deemed have assumed any liability or responsibility by permitting information regarding itself, and its financial statements, to be included in this disclosure document.

2. Dissemination of Irrelevant, and Possibly Misleading, Information to Prospective Franchisees

Another ground underlying the NFC's request that the FTC reconsider its determination to compel franchisors to disclose much information regarding their corporate parents (in circumstances where such parents are not offering franchises in any line of business or providing products or services to the franchisees of the subject franchisor) is that such a mandate will lead not only to an unnecessarily lengthy disclosure document, but also to the dissemination of much misleading information.

If applied to the Union Carbide Corporation, the NPR would require that company's franchisor subsidiary to disclose Union Carbide's "prior business experience" (see NPR, §436.5[a][7]). The Union Carbide Corporation is one of America's oldest corporations. Describing its "prior business experience" would consume upwards of 10-20 full pages of text in its subsidiary franchisor's disclosure document - - all of which would prove utterly irrelevant to a prospective franchisee of that subsidiary franchisor.

Similarly, the FTC's proposed Disclosure Item 3 (NPR §436.5[c]) - - which would require a franchisor to set forth its parent's litigation history - - would massively and unnecessarily bulk up its subsidiary franchisor's disclosure document. Again using the Union Carbide Corporation as an example - - and noting that the NPR would require disclosure concerning all pending actions charging Union Carbide with fraud, unfair or deceptive practices or comparable obligations, as well as disclosure regarding all actions during the prior ten year period in which Union Carbide had been held liable in any civil action whatsoever (with no limitation) - - the FTC should understand that Union Carbide's franchising subsidiary's disclosure document would likely feature upwards of thirty or more pages of such disclosure, recalling that Union Carbide is an entity that has worldwide operations. All of which disclosure would be utterly irrelevant and immaterial to a prospective franchisee of Union Carbide's franchising subsidiary - - save for that franchisee's subsequent ability to argue that, given such massive disclosure regarding Union Carbide, that company should be held liable for the acts, errors and/or omissions of its franchising subsidiary.

Union Carbide was hardly the only parent of a franchisor whose experience, worldwide operations and litigation history are so massive that disclosure of same would unnecessarily and most significantly lengthen the franchisor's disclosure document while affording no material information to prospective franchisees. To the contrary, over the past ten years the trend has been for similar large companies - - frequently with decades or even centuries of experience and worldwide operations - - to acquire American franchisors. Bass plc now owns Holiday Inn and Inter-Continental Hotels. Diageo plc (the entity formed when Grand Metropolitan plc merged with Guinness) now owns Burger King. Allied Domecq now owns both Dunkin Donuts and Baskin-Robbins. Viacom, Inc. now owns Blockbuster, Inc. Each of these franchisors' "parents" have a massive worldwide presence; decades (sometimes even centuries) of "experience" subject to disclosure; and, much litigation (a natural consequence of the scope of their operations). Again, to require the

NPR-envisaged extensive disclosure of such parents' background; experience; litigation; and, financial statements may, in the end, add up to one hundred pages of unnecessary bulk to their franchising subsidiaries' disclosure documents while affording no benefit whatsoever to prospective franchisees reviewing that document.

* * * * *

For all of the reasons set forth above, the NFC respectfully requests that the FTC reconsider the NPR provisions requiring disclosures concerning a franchisor's corporate parent save for those situations where said parent is offering franchises in any line of business or is providing products or services to the franchisees of the subject franchisor.

D. Negotiation of Initial and Ongoing Fees

Section (C)(8)(e) if the NPR (at page 30) states that the proposed revisions to the FTC Franchise Rule "...clarifies that franchisors can negotiate with a prospective franchisee over the initial fee without potentially violating the Rule".

However, it conditions this clarification on the franchisor's stating a "range of fees, instead of a fixed fee" in its disclosure document, the presumption being that only negotiations within such a "range of fees" would be permissible under the Rule.

We respectfully submit that such a result will have an adverse impact on the interests of franchisees. It is frequently the case that a franchisor's disclosure document will specify only a fixed initial franchise fee and fixed ongoing royalties and advertising contributions, with no anticipation that these will be varied from. However, it is also frequently the case that, in an unanticipated fashion, these fees must be negotiated down in favor of the prospective franchisee. This occurs where the prospective franchisee has particular characteristics warranting such a diminution of initial and/or ongoing fees - - a commitment by the franchisee to open many units instead of one; the background, experience and qualifications of the prospective franchisee; or, when the prospective franchisee is a "conversion franchisee" who has massive experience in the subject business sector and is willing to "convert" his/her/its existing business (with its large customer base) to the franchisor's brand.

In such circumstances, it 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).[5]

E. Financial Performance Information

The NFC strongly concurs with the FTC's observation in its NPR that disclosure of financial performance information should remain voluntary and should not be mandated by the revised FTC Franchise Rule.

The NFC also concurs that franchisors should include prescribed preambles in Item 19 of their disclosure documents to clarify the law regarding financial performance claims. However, to best achieve the FTC's NPR-stated goals, we suggest the following modifications to the proposed Disclosure Item 19 "clarifying language" (NPR §436.5[s]) (proposed additions are underscored, deletions are stricken):

> (i) The FTC's Franchise Rule permits a franchisor <u>to include in this disclosure document</u> ~~to provide~~ information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets...or (ii) a franchisor provides financial performance information in <u>this</u> Item 19 and supplements that information by providing, for example, information about possible performance at a particular location <u>or under particular circumstances</u>.
>
> (ii) If a franchisor does not provide any financial performance representations, also state: ~~this franchisor does~~ <u>We do</u> not make any representation~~s~~ about ~~a~~ <u>your franchise's future</u> ~~franchisee's~~ financial performance <u>or the past financial performance of our company-owned or franchised units</u>. We also...

The first proposed modification set forth above would, we believe, improve the current NPR language, which otherwise could be misconstrued by both franchisors and

---

[5] This clarification has judicial support. In the landmark case of <u>The Southland Corporation v. Attorney General of New York</u>, 148 Misc.2d 390, 560 N.Y.S.2d 253 (Sup.Ct., N.Y.Cty., 1990), the New York Attorney General espoused the position that a franchisor could not negotiate its fees downward in favor of a prospective franchisee, in this case the largest multi-unit franchisee in the State of New York (The Riese Organization). In a judicial challenge commenced by Southland (with the Riese Organization's full support), the Attorney General's position was forcefully rejected by the court, which held that a franchisor could always negotiate downward from the initial and/or ongoing fees specified in its disclosure document. To conclude otherwise, observed the court, would injure the very franchisee whom the Attorney General was ostensibly protecting.

their prospective franchisees to mean simply that the FTC Franchise Rule permits a franchisor to provide financial performance information in general. The modifications made to subparagraph (ii) above merely attempt to clarify the type of financial performance information which is not being disseminated by the subject franchisor and to incorporate "plain English" into the paragraph.

Further, the NFC respectfully submits that the Commission should take this opportunity to clarify once and for all that a franchisor's dissemination of "expense only" information to prospective franchisees - - whether or not such "expense only" information is contained in that franchisor's disclosure document - - does not of itself constitute the making of an illegal "earnings claim".

First, as the Commission itself acknowledges in the NPR (Section "H" [2][Definition 2]): "...(T)he Commission does not consider the disclosure of such expense information (i.e., that disclosed in the franchisor's disclosure document) alone to constitute the making of a financial performance claim" (<u>NPR</u> at 92). But while the NPR states that "...the proposed definition of 'financial performance representation' - - section 436.1(d) - - specifically omits expense information", that omission is by inference only. The NFC respectfully requests that the Commission clarify in revised Rule §436.1(d) that, indeed, a franchisor's dissemination of the very franchisee expense information required to be disclosed in Disclosure Items 5 - 7 and 10 will not be deemed to constitute that franchisor's disseminating or making a "financial performance representation".

But the NFC also respectfully suggests that the FTC go further and make clear that a franchisor may freely disseminate franchisee expense information other than that required to be disclosed in the above-cited Disclosure Items without being deemed to have made a financial performance representation. The reasoning is simple. No franchisee (or any other individual or entity) can possibly understand, derive or infer "a specific level or range of potential or actual sales, income, gross profits, or net profits" (revised Rule's definition of "financial performance representation" at §436.1[d]) from expense data only. At least some information regarding historic or potential sales, revenues, income or other earnings of the franchised business is necessary for a franchisee to translate expense-only information into a stated or inferred level or range of income, gross profits or net profits.

Indeed, if the NFC's requested modification is effected, franchisors could furnish to their prospective franchisees "worksheets" identifying expense information, leaving it to the prospective franchisee to obtain revenue information from other existing franchisees (or to estimate same with the aid of accountants or other advisors), an exercise which would prove most fruitful to that prospective franchisee's investment decision.

Of course, as before, a franchisor's dissemination of misleading or false expense information would be actionable under both the FTC Franchise Rule and applicable state franchise laws (which provide not only civil but criminal penalties for such conduct).

Accordingly, the NFC respectfully suggests that the Commission make clear in §436.1(d) of the revised Rule that a franchisor's dissemination of any and all expense information - - both that information required to be set forth in the franchisor's disclosure document and other such information - - will not be deemed that franchisor's making a "financial performance representation".

Finally, the NFC respectfully requests that the NFC exclude from its definition of "financial performance representation" a franchisor's dissemination to existing franchisees of any and all financial performance data (including revenues and expenses) it may possess, either systemwide or with regard to particular units, locations or circumstances. These existing franchisees almost universally desire to obtain such information, either in connection with their interest in acquiring additional franchised units or bettering the performance of their existing franchised units. As the NFC respectfully notes below (see Section IV[I][2] infra. at page 18), experienced franchisees should be exempt from disclosure altogether (as they are in many states). But even if the Commission chooses not to effect such an "experienced franchisee" disclosure exemption, such existing 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. The Commission has only to witness a franchisor's annual convention of franchisees - - where franchisors are restricted from disclosing this very type of information that franchisees are seeking - - to understand the merit of the NFC's requested revision.

Again, if such an exemption is afforded so that franchisors can freely disseminate such information to existing franchisees - - but those franchisors disseminate false or misleading information - - such conduct is punishable under both federal and state franchise laws, rules and regulations.

For all of these reasons, the NFC respectfully suggests that the Commission make clear in revised Rule §436.1(e) that a franchisor may freely communicate or disseminate financial performance information to its existing franchisees, whether they are considering acquiring additional franchises or not, but in any event subject to the Rule's (and state franchise law) anti-fraud provisions.

F. Fourteen Day Disclosure Review/Five Day Contract Review Periods

The NFC commends the Commission's proposal that the "first personal meeting" disclosure trigger be abandoned as obsolete in this age of electronic communications; that the "ten business day" disclosure document review period be restated as fourteen calendar days; and, that the Rule's "five business days" contract review period be reduced to five calendar days (NPR §§[C][5][c] and[d]). In this fashion, a franchisee will have more than adequate time to review the subject disclosure document and franchise agreement (and consult with an advisor regarding same) while permitting franchise sales transactions to proceed without undue delay, a common desire shared by both franchisors and franchisees.

However, the NFC believes that the proposed Rule's "five business day" contract review period may inadvertently preclude franchisee-induced negotiated changes to the subject franchise agreement. That is, should the parties meet to execute the franchise agreement and, at such time, the franchisee requests certain changes be made thereto in its favor - - and such changes are, in fact, accomplished by the franchisor - - the franchisee could subsequently advance an argument that it did not have yet another five days to review the contract. Accordingly, we would request that the Commission clarify that the five day contract review period is exclusive of changes to the subject franchise agreement made less than five days prior to the execution thereof at the request of the franchisee.

Set forth below, under the heading "Section-By-Section Comments", are certain minor text changes we would recommend be effected by the Commission to the revised Rule provisions addressing these issues.

G. Electronic Disclosure

The NFC most strongly commends the FTC's proposal that franchisors be free to utilize electronic media to the fullest extent possible to furnish their disclosure documents (NPR §§[D][10][a] - [g] and revised Rule §436.2).

As the Commission has observed, electronic disclosure will reduce franchisors' disclosure compliance costs. Indeed, we believe that the NPR significantly understates the potential cost savings by focusing only on printing and mailing expenses and not the considerable administrative costs incurred by franchisors in furnishing disclosure documents.

More importantly, electronic disclosure will enable those franchisees who desire to more quickly obtain a franchisor's disclosure document and, through cross-links to the subject franchise agreement, enable them to more intelligently review and understand those documents. For example, under today's "paper only" disclosure protocol, a franchisee reviewing the various UFOC tables (those in UFOC Item 9 specifying the franchisee's principal obligations and Item 17 regarding the termination, renewal, transfer and dispute provisions of the subject franchise agreement) must constantly shift back and forth between the disclosure document itself and the franchise agreement provisions it describes. Enabling electronic disclosure with internal cross-links between the 23 Items in the disclosure document and the subject agreement(s) eliminates this time consuming and oft-confusing task, thus affording a more intelligent review of the document by a franchisee.

Further, the NFC believes that a prospective franchisee's ability to access a great number of franchise disclosure documents will be greatly fostered through the revised Rule's electronic disclosure provisions. We can clearly anticipate the day when various Internet sites will feature a vast number of franchisors' disclosure documents. The ability to swiftly access same - - and compare/contrast their provisions - - will enable a prospective franchisee to “comparison shop” in an unprecedented and altogether optimal fashion that will improve the functioning of an already robust marketplace.

Finally, the Commission’s narrow requirement that a franchisor engaging in the electronic delivery of disclosure documents furnish prospective franchisees with a paper summary document and a special receipt are meritorious. Also meaningful is the proposed revision to the Rule that would require franchisors to retain specimen hard copies of all materially different versions of their electronic disclosure documents.

However, the NFC respectfully suggests that a few minor changes to the requirements of proposed §436.7 of the revised Rule may be effected without deleteriously affecting a prospective franchisee’s receipt of full and complete disclosure via electronic modes. Specifically, we propose that the FTC permit franchisors to deliver the paper summary document to prospective franchisees through electronic means - - by e-mail, a website, or facsimile - - and permit the prospect to return the Acknowledgment of Receipt by facsimile, mail or electronically with an acceptable electronic signature. We note that such paper summary should also include the Internet address of any third-party provider/common electronic platform through which the franchisor’s document is being made available.

Additionally, the NFC submits that the requirement that a prospective franchisee consent in advance to receiving electronic disclosure be eliminated (see proposed revised Rule, §436.7[a]). As the Commission notes in its NPR, it “...does not wish to impede franchisors’ ability to maximize the use of new technologies in their efforts to comply with the Rule”. However, the NFC fears that an advance consent precondition to electronic disclosure would do just that. We envision the day when franchisors will routinely post their UFOC’s either on individual Web sites or through a common electronic platform geared to aggregate such UFOC’s for access by the general public (which would greatly enhance a prospective franchisee’s ability to “comparison shop” among various franchisors). A “prior consent” precondition to electronic disclosure would frustrate the Rule’s otherwise seamless paradigm for effecting disclosure through such modes for no apparent purpose. Prospective franchisees who receive disclosure via electronic means will be receiving (pursuant to proposed Rule §436.7[b]) a special paper summary document and special Item 23 Receipt insuring both that the franchisee in question intended to receive electronic disclosure and, perhaps more significantly, that its franchisor cannot subsequently claim that is then-prospective franchisee received disclosure via electronic means when, in fact, that franchisee did not. In short, the “advance consent” precondition to electronic disclosure is a cumbersome one that may serve no purpose.

In the same vein, and to assuage the Commission’s concern that franchisee consent to electronic disclosure be clearly evidenced, the NFC suggests that revised Rule §436.7(b)(3) be revised so that the Item 23 Receipt of the “paper summary document” varies somewhat from the franchisor’s usual “Item 23 Receipt”, by explicitly setting forth the franchisee’s acknowledgment that it had consented to electronic disclosure and received the “summary document” itself.

Finally, the NFC is concerned about how franchisors can comply with revised Rule Section 436.8(c). If, for example, a prospective franchisee receives an electronic version of a disclosure document on January 1, 2000, and is still in the sales cycle on January 1, 2001, would a franchisor be required to have provided this prospect with three separate quarterly updates related to material changes since the prior quarter? This provision would seem to require franchisors to keep a log of the date of each Acknowledgment of Receipt, and then to forward any necessary future quarterly updates to all prospects as of a certain date. If this is the case, how does a franchisor determine that a prospect who has received a version of the disclosure document is no longer a “prospect” for purposes of providing quarterly updates? It is unclear whether franchisors must notify such “deleted prospects” in order to avoid non-compliance with revised Rule Section 436.8(c).

H. Updating Disclosure Documents

NPR Section (C)(11)(a) - (d) and Revised Rule §436.8 contemplate that franchisors will be required to update their disclosure documents at various specified times.

As before, annual updates will be required to be effected within ninety days following the close of a franchisor’s fiscal year to insure inter alia that said franchisor’s audited financial statements for such fiscal year are included in the disclosure document. Also as before, proposed revised Rule §436.8(b) would mandate that franchisors update their disclosure documents at least quarterly to reflect any “material changes”.

Further, proposed Rule §436.8(c) - - a new provision - - would require franchisors to notify prospective franchisees about material changes that may have transpired since such prospects received their disclosure documents. Although the NPR (at 69) suggests that this notification may be communicated by the franchisor orally or in writing, the proposed Rule provision itself does not so state.

The NFC is in accord with the Commission’s post-quarterly update “material change” disclosure requirement. But we would be grateful if the Commission made clear in the subject Rule provision itself that such post-quarterly update “material change” disclosures could be effected not only by means of amendment to the franchisor’s disclosure document, but alternatively by means of other written communications (to use the Commission’s example, a faxed letter) or oral statements.

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 documents 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.

I. “Sophisticated Investor” Exemptions

1. The Changing Nature of the American Franchisee Population

The NFC most strongly commends the Commission for its foresight in identifying and addressing a critical developing trend in franchising - - the emergence over the past decade of a class of “sophisticated franchisees” whose knowledge, experience, financial resources and access to professional advisors render them capable of demanding and receiving information from their prospective franchisors that equals or exceeds the disclosures required by the Rule.

Accordingly, the NFC strongly urges the Commission to adopt the “sophisticated investor” exemptions to disclosure addressed in Section (C)(12)(e) of the NPR (proposed revised Rule §436.9[e]), as slightly modified in the fashion indicated below.

As the FTC clearly full well understands, the face of the United States franchisee population has dramatically changed over the past decade. While franchising’s roots may be traced to the grant of an individual franchise to one entrepreneur (or a small group of entrepreneurs) possessing no prior knowledge of or experience in the subject industry (sometimes colloquially referred to as “mom and pop” operations), 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 franchises, and (ii) existing franchisees whose experience, profitability and mastery of the franchisor’s system strongly suggest future success.

Sometimes, this determination results in the grant of multiple unit franchise rights within a defined geographic area (city/county/state/region of the United States). Other times, a franchisor elects to only grant new domestic franchises to pre-existing and proven franchisees. Yet other times, franchisors will grant franchise rights to non-traditional locations to sophisticated entities having vast experience in operating in such environments (as when major quick serve restaurant franchisors afford franchise rights to experienced guest lodging chains for room service, or when other quick serve franchisors grant franchises for the operation of airport units to large entities having vast experience in institutional food service operations).

The economic logic underlying these trends is compelling. With regard to restricting the grant of domestic franchises only to experienced franchisees, the logic is simple: instead of assuming the risk of an unknown, untrained and inexperienced franchisee candidate, it is far better to grant the subject franchise to an experienced franchisee whose qualifications, skills, background and financial wherewithall are already known to the franchisor; who has already undergone training; who has mastered the many details of the franchisor’s system; and, whose previous successful operation of a franchised unit (with all of the managerial, operational and financial skills required) strongly suggests future success at the newly franchised location. Similar logic pertains to a franchisor's grant of franchises to large corporations with significant net worth and substantial experience in the subject industry. Sometimes these two trends merge - - one of the NFC's members, which dominates its quick serve restaurant market segment, has as its largest franchisee a corporation which operates over 800 franchised restaurants; is a publicly traded corporation listed on the New York Stock Exchange; and, until recently, also served as the franchisor of another, smaller quick serve restaurant chain.

Indeed, as reported in the December 1, 1999 edition of Restaurant Business, the "Top 50" American restaurant franchisees (in terms of U.S. sales) collectively own and operate over 7,500 units (citing Restaurant Franchise Monitor's "Top 200 Franchisee List"). And according to the most recent Franchise Times survey of franchise owners, fully 36% of survey respondents reported owning more than one franchised unit (Franchise Times, September, 1999, at page 21). This accords with the 1997 Franchise Times annual franchisee survey, the details of which revealed that 36% of survey respondents owned more than one franchised unit (with fully 17.6% owning three or more franchised units). Erdos & Morgan, Franchise Times Study: May 1997, Table 003.

The experience of the National Franchise Council's members bears this out. An informal poll of the NFC's quick serve restaurant members reveals that in excess of 90% of all new domestic franchises granted by them are afforded either to pre-existing franchisees or large corporations having vast experience in the subject business.

2. Expanding The "Sophisticated Investor" Exemption to Embrace Sales to Experienced Franchisees

While the NFC strongly lauds the Commission's appreciation of the changing nature of the American franchisee population and the "sophisticated investor" disclosure exemption afforded by the proposed revised Rule, we also respectfully suggest that that exemption can be slightly modified to expand the definition of a "sophisticated investor" without sacrificing the concept that only true "sophisticated investors" should be exempted from receiving disclosure documents.

Specifically, the NFC respectfully suggests that sales to an existing franchisee who has operated his/her/its franchised unit for at least two years should be exempted from the Rule's disclosure requirements. Such franchisees already possess sufficient experience, knowledge and sophistication in the nuances of the subject franchise system (including relationships with the franchisor in question) to far eclipse any information set forth in their franchisor's disclosure document. Certain states have already adopted such an exemption. For example, California relieves a franchisor from having to register its offering document and disseminate same to any prospective franchisee where:

> The offer, sale or other transfer is of an additional franchise to an existing franchisee of the franchisor, or to an entity, one or more of the officers, directors, management agents or owners

> of at least a twenty five percent interest of which is an existing franchisee of the franchisor; provided that, in either case, for 24 months or more the franchisee, or the qualifying person, has been engaged in a business offering products or services substantially similar to those to be offered by the franchise being sold, or otherwise transferred.

See California Franchise Investment Law, California Corporations Code, Division 5, Parts 1 through 6, Sections 31000 et seq., §31106(a)(3).

Similarly, New York exempts from the New York Franchise Act's registration and disclosure requirements a franchisor's offer and sale of a franchise to an existing franchisee where:

> (i) The existing franchisee has actively operated a franchise of the selling franchisor for the eighteen months preceding the offer; and,
>
> (ii) The existing franchisee purchases the franchise in order to operate the business and not for the purpose of resale; and,
>
> (iii) The franchisor reports the sale to the department of law on the form required by the department within fifteen days of the sale.

See New York Franchise Act, General Business Law of New York, Article 33, Sections 680 et seq., §684(d).[6]

---

[6] Similar exemptions are afforded by the franchise-regulating states of Hawaii (Section 482E-4(a)(6) of the Hawaii Franchise Investment Law, Hawaii Revised Statutes, Title 26, Chapter 482E, Sections 482E-1 et seq.); Maryland (Section 14-214[b][2] of the Maryland Franchise Registration and Disclosure Law, Annotated Code of Maryland, Article - - Business Regulation, Title 14, Sections 14-201 et seq.); Michigan (Section 445.1506[e] of the Michigan Franchise Investment Law, Michigan Compiled Laws, Chapter 445, Sections 445.1501 et seq.); Rhode Island (same two year experiential requirement suggested by NFC herein) (Section 19-28.1-6(e) of the Rhode Island Franchise Investment Act, General Laws of Rhode Island, Title 19, Chapter 28.1, Sections 19-28.1-1 et seq.); the State of Washington (Section 19.100.030(6) of the Washington Franchise Investment Protection Act, Revised Code of Washington, Title 19, Chapter 19.100, Sections 19.100.010 et seq.); and, Wisconsin (Section SEC 32.05[e] of the Wisconsin Administrative Code, Chapters SEC 31 - 36, Sections SEC 31.01 et seq.).

Accordingly, the NFC recommends that the Commission strongly consider expanding the "sophisticated investor" exemption set forth in proposed Rule §436.9(e) by exempting franchise sales to an existing franchisee who has operated his/her/its franchised unit for at least two years.

3. The $1.5 Million Dollar Investment Exemption

Under proposed revised Rule §436.9(e)(1), franchisors would be exempt from the Rule's disclosure obligations when offering and selling franchises to franchisees whose initial investment will total at least $1.5 million dollars.

The NFC believes that this figure can be reduced to one million dollars ($1,000,000) without deleteriously impacting the Commission's goal of eliminating disclosure only where the size of the franchisee's initial investment reflects the franchisee's sophistication, experience and ability to procure more information from the franchisor than may be set forth in the subject disclosure document. At that one million dollar initial investment figure, prospective franchisees - - as the Commission correctly notes - - are not likely to purchase a franchise on impulse; are more likely to negotiate the terms of the subject franchise agreement; and, are more resistant to high pressure tactics. (Incidently, while we assume that the Commission's initial investment exemption applies to the "initial investment" specified in Disclosure Item 7 (proposed Rule §436.5[g]), §436.9[e][1] of the proposed Rule does not state that explicitly - - it simply uses the term "franchisee's estimated investment". Perhaps the Commission would want to clarify that this phrase means "initial investment" to conform this provision with Disclosure Item 7 [Rule §436.5[g].)

Further, the NFC believes it critically important for the Commission to consider revising this provision of the proposed Rule to make clear that prior investments made by the franchisee in assets or activities which will be devoted to the subject franchise may satisfy the Rule's exemption threshold. This modification is requested so that the exemption logically extends to "conversion franchise activity" - - where existing and operational businesses become franchisees and devote their pre-existing physical plant, labor force and other assets to the franchise. As the Commission knows, this 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 (whether independent or franchised under another chain's "flag") to the name, mark and system of a guest lodging franchisor. The same conduct pertains in the real estate brokerage arena; the quick serve restaurant sector; the automobile rental sector; the retail store arena; and, many other segments of franchising.

The NFC respectfully submits that a previous investment in excess of the threshold amount made by such "conversion franchisees" should logically count toward satisfying the threshold specified in Section 436.9(e)(1) of the proposed Rule. Any business that has previously invested that sum prior to executing the subject franchise agreement - - and has been operational (either as an independent or as a franchisee of another chain) - - will possess even more “sophistication” than a new business entrant investing that sum. To use the most extreme example, consider the situation where one of America’s premier guest lodging franchisors grants a franchise to an existing major resort complex situated in Hawaii whose construction cost exceeded $200 million dollars. Very little new “initial investment” would be required of such a franchisee - - but that franchisee’s prior expenditure of funds and obvious sophistication should suggest to the Commission that it is in no need of the subject franchisor’s single unit franchise disclosure document.

The NFC’s requested expansion of the “sophisticated investor” exemption addressed herein would also cover those situations where franchisees acquire, in a transfer scenario, existing franchised operations and enter into new franchise agreements with the subject franchisors. Again, presuming that the purchase price of the business exceeded the threshold amount, we respectfully 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.

Finally, the NFC believes that it is critical for the Commission to clarify that the subject “franchisee’s estimated investment” applies to that franchisee’s total investment, and not just investment in a single unit. 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. Since Disclosure Item 7 of the revised Rule will refer to a franchisee’s “initial investment” in terms of unit costs, some confusion may arise. Thus, our recommendation that the Rule clarify that an aggregate franchisee investment equal to or exceeding the threshold amount would satisfy the exemption requirements of this Rule provision.

For all of the reasons set forth above, the NFC respectfully suggests that proposed Rule §436.9(e)(1) be modified as suggested herein.

4. The Large Corporate Franchisee Exemption From Disclosure

Section 436.9(e)(1) of the revised Rule would exempt a franchisor from having to make disclosure to “large corporations” (NPR at 74) - - defined as those corporations which have “...been in business for at least five years and (have) a net worth of at least $5 million (dollars)”.

The NFC believes that this section of the proposed revised Rule may be slightly modified and clarified without detracting from the Commission’s goal of only exempting those franchise sales transactions when the franchisees in question are “sophisticated investors”.

First, the NFC questions why any experiential requirement should attach to the “large corporate franchisee” exemption (such as the Commission’s proposed five year experiential requirement). Any business so capitalized as to have a net worth of at least

$5 million dollars, we respectfully submit, is already “sophisticated”. Indeed, to use the Commission’s own NPR language: “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” (NPR at 75).

Further, we respectfully submit that the Commission should understand that very frequently - - for corporate organizational, liability and/or tax purposes - - large corporate franchisees (many of whom have been in business for decades) will create a new corporate entity (usually a subsidiary or affiliate) for each new franchised unit it constructs or acquires. Other multi-unit franchisees may forego creation of a parent entity altogether, electing instead to control a number of single purpose entities. For example, one of the NFC’s members in the quick serve restaurant sector has a franchisee which owns over 700 restaurants and is one of the largest privately owned restaurant operators in the world. But often when that franchisee constructs (or acquires) a new restaurant, it sets up a new corporate vehicle for that restaurant. We submit that such transactions should logically be exempted. Accordingly, the Rule should provide for the aggregation of commonly-owned franchisee assets for the purpose of determining eligibility for the “large corporate franchisee” disclosure exemption. (If this NFC suggestion is adopted, the definition of the term “affiliate” as set forth at proposed Rule §436.1[b] will have to be expanded by adding the words “or franchisee” at the conclusion thereof.)

Further, proposed Rule Section 436.9(e)(2) only affords the subject exemption if the franchisee is a “corporation”. As the Commission knows, there are many other business forms which are the functional equivalent of corporations - - limited partnerships; limited liability corporations; general partnerships; and so forth. We respectfully suggest that the Commission’s proposed “sophisticated investor” exemption should apply to such forms of business entities as well.

Finally, with regard to the Commission’s intent to publish revised thresholds for the “sophisticated investor” exemption once every four years to adjust for inflation (NPR at 75), the NFC respectfully suggests that the Commission can relieve itself of this obligation by providing that the threshold amount will be automatically adjusted upward to reflect increases in the Consumer Price Index - - while placing the burden on the subject franchisor to demonstrate that, in fact, it qualified for the “sophisticated investor” exemption at the time in question. In this fashion, the Commission’s goal of adjusting the “sophisticated investor” threshold upward to account for inflation may be satisfied without the Commission’s having to revisit the issue every four years.

Given the above, the NFC respectfully suggests that proposed Rule §436.9(e)(2) be revised as follows:

> The disclosure requirements of sections 436.2 - 436.8 of this Rule shall not apply if the franchisor can establish any of the following:

(e)(2) the franchisee is ~~a corporation~~ an organized business entity (including, without limitation, a corporation; limited partnership; limited liability company; general partnership; or a functional equivalent) ~~that has been in business for at least five years~~ 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.

5. Proposed Exemption Afforded to Officers, Directors, Etc. of the Franchisor

The NFC strongly endorses the Commission's proposed "sophisticated investor" exemption afforded to a franchisor's current or former officers, directors, managing agents or owners, as set forth in §436.9(f) of the proposed Rule.

However, the NFC respectfully suggests that this particular "sophisticated investor" exemption be expanded 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". Such terminology derives in a logical fashion from the scope of persons required to be disclosed in Disclosure Item 2 (proposed Rule, §436.5[b]) as well as the modification thereto suggested by the NFC above (see Section [IV][A] - - "De Facto Officers" - - at page 2, supra.).

The NFC sincerely believes that the modification requested herein would not in any fashion deleteriously affect the stated goal of the Commission to only afford disclosure exemptions when franchise sales are transacted with truly "sophisticated" franchisees.

J. Additional Prohibitions - - Financial Performance Statements

The NPR (at 77-78) suggests that the Commission's current restrictions on a franchisor's dissemination of financial performance representations outside of its disclosure document - - including the general media, Internet advertising and unsolicited commercial e-mail - - will continue (see proposed revised Rule §436.1[d]).

However, the NFC respectfully suggests that the Commission can clarify a widely held misunderstanding regarding this prohibition on representations made in the "general media". As noted in the NPR (at 77), what the Commission seeks to address through address this prohibition are advertisements (broadly defined to include broadcast and published ads, Internet content, mailings and any other form of advertising) paid for and placed by a franchisor which state or suggest "financial performance representations" (as defined by the proposed Rule §436.1[d]) not found in that franchisor's disclosure document. However, the phrase "general media" can mistakenly be assumed to include interviews granted by executives of franchisors; press releases; securities filings of publicly held franchisors (including, without limitation, Forms 10-Q and 10-K); and, similar such public pronouncements which appear in "general media".

The NFC respectfully suggests that the Commission clarify (definitionally or otherwise) that the prohibition on a franchisor's making financial performance representations in "general media" is confined to advertising or promotional material whose principal purpose is to solicit prospective franchisees and/or influence their investment decisions, and does not extend to representations otherwise made by a franchisor in "general media" which do not have that principal purpose. Of course, the NFC fully understands that, as before, if a franchisor makes financial performance representations in the course of granting a broadcast or printed interview (for instance, in the Wall Street Journal), that franchisor cannot take that printed interview and use it to solicit franchisees or influence their investment decisions; the use of general media representations in such a fashion would continue to be deemed franchise "advertising" prohibited if the subject franchisor did not set forth in Item 19 of its disclosure document the financial performance representations at issue.

K. Effect on Other Commission Laws

Section (C)(14) of the NPR (at 81) ("Effect on Other Commission Laws") states: "...the Commission reserves the right to pursue violations of antitrust laws even if a franchisor discloses the violation in complying with the Rule's disclosure requirements. In short, disclosure does not create a safe harbor for franchisors engaging in otherwise unlawful conduct" (emphasis added).

The NFC respectfully requests that the Commission alter this language in any forthcoming interpretive guide or statement of basis by accompanying the Commission's promulgation of the revised Rule. For under applicable decisional law, it may well be that a franchisor's disclosure in its disclosure document of certain product or sourcing restrictions may, in fact, relieve that franchisor from antitrust "tying" liabilities.

As the Commission is aware, the seminal U.S. Supreme Court case addressing this "tying" issue is Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451, 112 S.Ct. 2072, 119 L.Ed.2d 265 (1992). In that case, independent photocopier repair companies challenged Kodak's abrupt change of policy - - denying them access to Kodak parts and instead requiring Kodak customers to purchase both repair service and replacement parts from the company itself - - as an illegal "tie" in per se violation of the Sherman Act. In affirming the lower court's denial of summary judgment to Kodak (which argued that it possessed insufficient "market power" and therefore could not as a matter of law exercise any market power in the aftermarket for service), the U.S. Supreme Court placed great reliance on the fact that Kodak's equipment purchasers had no advance notice that such a shift in policy could be forthcoming and, absent such notice, could not make intelligent purchase decisions, but rather were "locked in" in ignorance that a "tie" could be forthcoming.

Following the decision in Kodak, a number of franchise cases addressed the issue of whether a franchise agreement's sourcing restrictions prohibiting franchisees from purchasing products other than from the franchisor or from franchisor-approved sources constituted an illegal "tie" in violation of the Sherman Act. The majority of courts have held that, since franchisors disclose in advance in their disclosure documents any sourcing restrictions that franchisees must adhere to, Kodak does not apply, since the evil perceived therein - - an unanticipated post-contractual change of policy resulting in a "lock-in" between Kodak and its photocopier customers - - is not present. See Queen City Pizza, Inc. v. Dominos Pizza, Inc., 922 F.Supp. 1055 (E.D.Pa. 1996) aff'd. 124 F.3d 430 3d Cir. 1997); Wilson v. Mobil Oil Corp., 940 F.Supp. 944 (E.D.La. 1996) ("...there is growing Circuit authority which this Court cannot ignore recognizing that the effect of advance disclosure of a tying arrangement is to prevent the purchaser from being locked in...The risk of being (locked in)...was disclosed, and plaintiffs have given no reason why they could not have shopped for another franchise if they found that risk unacceptable") (Id. at 459 - 461); and, Valley Products Co., Inc. v. Landmark, a Division of Hospitality Franchise Systems, et al., 128 F.3d 398 (6th Cir. 1997) (strongly emphasizing the Sixth Circuit's support of Queen City, cited supra.).

Accordingly, the NFC respectfully suggests that the Commission revise or eliminate the above-quoted NPR "safe harbor" language in any forthcoming interpretive guide or statement of basis accompanying the forthcoming Rule revision.

V. SECTION-BY-SECTION COMMENTS

In this segment of the NFC's comment letter, we shall track the proposed revisions to the FTC Franchise Rule on a section-by-section basis and advance comments upon such of those proposed revisions which are confined to but a single section thereof (cross-referencing to the above "General Comments" where appropriate).

A. Definitions (Rule §436.1)

1. "Action" (Rule §436.1[a]).

The NFC respectfully suggests that the Commission add the words "action or" between the words "judicial" and "proceeding" to make sure that both types of judicial activity are subject to disclosure under the Rule (in many states, judicial "actions" refer to actions-at-law, while "proceedings" are restricted only to equitable proceedings).

2. "Financial Performance Representation" (Rule §436.1[d])

In accord with the NFC's thematic comments set forth above (see Section IV[J] above - - "Additional Prohibitions - - Financial Performance Statements", supra. at page 23), the NFC requests that the definition of "financial performance representation" be modified to reflect that: (i) a franchisor's dissemination of bare expense information, standing alone, does not constitute a "financial performance representation", and (ii) that the phrase "a representation disseminated in the general media and Internet" subsumes only financial performance representations made by a franchisor in the general media and Internet whose principal purpose is to solicit prospective franchisees and/or influence their investment decisions, and does not extend to representations otherwise made by a franchisor in the "general media" or Internet, whether in the course of interviews, briefings or otherwise.

3. "Franchise" (Rule §436.1[g])

The NFC respectfully requests that the word "control" appearing in §436.1(g)(2)(i) be replaced with the word "influence". The reason is simple. Unfortunately, franchisors have had a number of vicarious liabilities thrust upon them for the acts, errors and/or omissions of their franchisees under the mistaken judicial notion that a franchisor "controls" its franchisees.[7] While the better informed and prevalent line of judicial decisions holds directly to the contrary - - that is, that a franchisor does not "control" the day-to-day operations of its franchisees such that vicarious liabilities should be thrust upon it, but only establishes, maintains and enforces system standards[8] still the 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. By substituting the term "influence" for "control", this mischief may safely be abated without sacrificing any of the Rule's salutary purposes.

4. "Gag Clause" (Rule §436.1[k])

To begin with, the NFC believes that the phrase "gag clause" is pejorative in nature and should be replaced with "confidentiality agreement" below.

The NFC's comment regarding disclosure of such communication restrictions is set forth below under its "Item 20" comment below.

5. "Internet" (§436.1[l])

The NFC believes that the Commission has defined the term "Internet" in precisely the correct fashion and wholly consistent with other agencies' definitions of

---

[7] See, e.g., J.M. v. Shell Oil Company, 992 S.W.2d 759 (Mo. 1996), rehearing denied (identical citation); Miller v. McDonald's Corp., 150 Or.App. 274, 945 P.2d 1107 (Or.App. 1997); and, Crinkley et al. v. Holiday Inns, Inc, et al., 844 F.2d 156 (4^{th} Cir. 1988).

[8] See, e.g., Cislew v. 7-Eleven, Inc., The Southland Corporation et al., 4 Cal.App. 4^{th} 1284, 6 Cal.Rptr.2d 386 (Cal.App., 4^{th} Dist. 1992) and, Salsbury et al. v. Chapman Realty, et al., 124 Ill.App.3d 1057, 465 N.E.2d 127 (Ill.App.,3d Dist. 1984).

“Internet” (including the Securities and Exchange Commission).

B. The Obligation to Furnish Documents (Rule §436.2)

The NFC respectfully suggests that the Commission clarify revised Rule §436.2(a)(2)’s reference to a “completed franchise agreement” by making the following modification (since a “completed franchise agreement” may mistakenly be understood to mean one which has been executed) (additions are underscored, deletions are stricken): “A copy of the ~~completed~~ franchise agreement <u>in the form to be executed</u>, and any related agreements <u>in such form</u>, at least five days before the prospective franchisee signs the franchise agreement”.

Further, the NFC believes that revised Rule §436.2(b) can be clarified by substituting the word “required” for the word “specified” at the end of the first sentence thereof (note that the next sentence refers to “the required date” - - thus, the foregoing recommendation for the sake of consistency).

C . Cover Page (Rule §436.3[g][2])

As the Commission knows, major franchisors may employ a number of senior executives or officers, sometimes in various locations throughout the United States, to oversee and effect that franchisor’s disclosure compliance activity. In a large organization, the individuals performing these functions may frequently change. Accordingly, the NFC respectfully recommends that the last sentence of the special cover page statement to appear on electronic disclosure documents be revised to eliminate the requirement that the name of a specific individual be disclosed thereat, substituting instead the title of the officer or executive in charge of the franchisor’s disclosure compliance activities.

D. Item 1: The Franchisor, Its Parents, Predecessors and Affiliates (Rule §436.5[a])

As detailed above, the NFC believes that the disclosure requirements concerning a franchisor’s “parent” and “predecessors” set forth in this Disclosure Item 1 would most significantly increase the size of many franchisors’ disclosure documents (especially those of major franchisors) without affording any material information to prospective franchisees - - in fact, possibly misleading them in a most material fashion (see Topic IV[B] [“Disclosure Concerning a Franchisor’s Predecessors”] and [C] [“Disclosure Regarding a Franchisor’s Corporate Parent”], <u>supra</u>. at pages 3-10).

As noted earlier, the NFC respectfully submits that disclosure regarding a franchisor’s “predecessors” should be limited to the period of time before the franchisor in question acquired the subject assets from its “predecessor” - - and be excluded altogether if the “predecessor” is an otherwise dormant intermediary corporation whose only function is to filter down the subject franchisor’s name, marks and know-how from the ultimate “parent” - - and that disclosure concerning a franchisor’s corporate parent be eliminated except for those situations where said parent is offering franchises in any line of business or is providing products or services to the franchisees of the subject franchisor.

E. Item 3: Litigation (Rule §436.5[c])

The NFC respectfully recommends that the Commission delete all litigation disclosure regarding a franchisor’s parent unless that parent is offering franchises in any line of business or is providing products or services to the franchisees of the subject franchisor (see discussion immediately above and cross-references therein).

Further, for the reasons stated under “Item 1" above, disclosure of a “predecessor’s” litigation history should be limited to the period of time prior to the subject franchisor’s acquisition of assets from that “predecessor”.

In addition, the NFC believes that disclosure of franchisor-initiated lawsuits should be curtailed to situations where a franchisor has sued a certain threshold percentage of franchisees in its system. Our recommended threshold is ten percent (10%).

Finally, and most critically, the NFC strongly urges the Commission to significantly revise the provisions of Disclosure Item 3(1)(iii)(B), addressing a franchisor’s obligation to disclose its being held liable in a civil action by final judgment during the immediately preceding ten year period. As stated, this provision sets forth absolutely no limitation - - not even a materiality standard - - curtailing the number of civil actions which must be disclosed in the subject disclosure document. As the Commission is aware, the parallel UFOC Guidelines requirement limits disclosure of such concluded civil actions to “...material action(s) involving violation of a franchise, antitrust or securities law, fraud, unfair or deceptive practices, or comparable allegations” (UFOC Guidelines, Item 3[B]) (the identical limitation which the Commission itself adheres to in Disclosure Item 3[iii][C]).

If disclosure of such Item 3 litigation is not restricted in this fashion, then the length of a major franchisor’s disclosure document will be remarkably increased with no concomitant benefit to prospective franchisees. Such a requirement will prove burdensome, prejudicial and of no real benefit to franchisees. Under this proposed Rule provision, if a franchisor is held liable in a municipal action for failing to file an awning erection form in sufficient time (as just recently happened to one of the NFC’s members), that judgment must be disclosed in the franchisor’s disclosure document. Or if, following a trade dispute with a printing concern which is litigated in small claims court, a judgment in the amount of $800.00 is entered against the franchisor, this too would have to be disclosed under Disclosure Item 3(iii)(B), as currently stated.

And if, as is contemplated by Disclosure Item 3(1), such actions against a franchisor’s parent and/or predecessor must be disclosed, the above-referenced problem will be compounded exponentially. Consider, for example, the ten year litigation history of

Union Carbide Marble Care, Inc.'s corporate parent, the Union Carbide Corporation. It would take upwards of one hundred pages to set forth that company's litigation history over the past ten years - - virtually all of which would be of no interest or value to a prospective franchisee of its franchising subsidiary.

Accordingly, the NFC respectfully requests that Disclosure Item 3(1)(iii)(B) be limited to, at the least, "material civil actions" and, ideally, material civil actions of the types denominated in immediately succeeding subsection (C).

F. Item 8: Restrictions on Sources of Products and Services (Rule §436.5[h])

The FTC would require, in Disclosure Item 8(3)(i), that franchisors disclose "[t]he criteria for evaluating, approving, or disapproving of alternative suppliers." By way of contrast, UFOC Guidelines Item 8, Instruction (vi), requires only that franchisors "[d]isclose whether the franchisor's criteria for supplier approval are available to franchisees."

The criteria used by franchisors in approving (or revoking the approval of) suppliers constitute highly sensitive trade secrets, and franchisors would be injured if this confidential information had to be disclosed. For this reason, the NFC strongly suggests that the FTC eliminate this proposed new requirement. If the FTC is determined, nonetheless, to retain the new provision, we respectfully request that it be revised so as to require disclosure of "[a] general description of the criteria for evaluating, approving, or disapproving alternative suppliers."

G. Item 12: Territory (Rule §436.5[l])

The NFC respectfully requests that the phrase "franchisee's market area" be deleted from subdivision (1) of this Disclosure Item 12 and that the words "franchisee's location" be substituted therefor (as in the UFOC Guidelines, Item 12, introductory language). The reason for this requested change is simple. The phrase "market area" is charged with significant consequences. While the majority of franchise agreements do not confer upon a franchisee the right to a specific "market area" (instead, most franchisees have rights only with regard to a specified location or a narrowly defined geographic area), franchisees and their advocates have for years, judicially and otherwise, sought to advance the notion that the grant of a franchise confers upon a franchisee exclusive rights within that franchisee's economic "market area", despite the terms of the subject franchise agreement and further without, most frequently, defining the term "market area". See, for example, the franchisees' pleadings in Carvel Corporation v. Baker et al., Not Reported in F.Supp., CCH Bus. Franchise Guide ¶11,208 (D.Conn. 1997) which, as quoted by the Court, stated: "Carvel has breached its contract and the implied covenant of good faith and fairness by directly supplying products in the franchisees' **market areas** at predatory prices..." (emphasis added). In this case, the Court had already expressly held that Carvel did not in any fashion breach the express territorial areas conferred upon its franchisees by their franchise agreements, but nevertheless permitted those franchisees - - inter alia under the "market area" theory - - to continue to press a claim that Carvel had breached the implied covenant.

No court has ever held that a franchisee enjoys a presumptive right to a "market area" as opposed to the specific location or limited geographic area (if any) afforded to that franchisee under his/her/its franchise agreement. Accordingly, the NFC respectfully requests that the Commission substitute the phrase "franchisee's location" for "franchisee's market area" in Disclosure Item 12(1).

Further, the NFC respectfully requests that the terms "area" and "defined area" - - as set forth in proposed Disclosure Item 12(1)(i) and (iv) - (vii) - - be deleted, with the phrase "limited protected territory" substituted therefor. An "area" is almost never granted unconditionally by a franchisor to any of its franchisees. At most, franchisees are granted limited territorial protections within geographic areas, with their franchisors reserving rights to engage in specified activities within such areas. By utilizing the phrase "limited protected territory" in lieu of "area" and "defined area", the Commission can actually reduce the misconceptions which otherwise may be engendered in the minds of prospective franchisees over what territorial protections, if any, they can expect to receive.

The NFC respectfully submits that the same change of terminology should be made to subdivision (2) of Disclosure Item 12.

On an organizational note, the NFC believes that Disclosure Item 12(2) may be deleted altogether, with subsections (i) and (ii) instead incorporated in subdivision (1) of Disclosure Item 12 (subdivision [2] otherwise being largely duplicative).

Finally, the NFC concurs with the Commission that the disclosure statement required of franchisors not granting territorial protection to their franchisees, as set forth in Disclosure Item 12(2)(ii), is more than adequate to alert such prospective franchisees about potential competition from within the franchise system.

H. Item 17: Renewal, Termination, Transfer and Dispute Resolution (Rule §436.5[q])

The NFC does not believe that the term "renewal" is misleading. We recognize, however, that it does not elucidate whether the agreement contemplates a simple extension of the existing agreement under the same terms or - - as is far more common - - the grant of a "successor franchise" under the terms being offered at the time that the existing agreement expires.

Because this item is intended only to direct a prospective franchisee to the applicable provisions of the agreement, we are uncertain whether this ambiguity compels revision of Item 17. However, should the FTC conclude that revision is necessary, we suggest two alternative approaches. First, the term “renewal” could be eliminated in favor of “Additional Term upon Expiration.” This approach has the advantage of simplicity. Alternatively, the category could be broken into two disclosure categories, namely “Renewal of Franchise under Same Terms” and “Renewal of Franchise Under Different Terms.” Under the latter approach, a franchisor that grants renewal rights under “then-current” terms would state “none” or “not applicable” in the table beside “Renewal of Franchise Under Same Terms” and, immediately below, cite the applicable provisions along side of “Renewal of Franchise Under Different Terms.”

I. Item 19: Financial Performance Representations (Rule §436.5[s])

The precise language changes which the NFC respectfully requests the Commission effect to this Disclosure Item are set forth above at Section IV(E) of this transmittal (at page 11).

Beyond such changes in syntax, the NFC is strongly concerned about the requirements set forth in NPR footnote 293 that a franchisor’s historic financial performance data must be prepared in accordance with United States generally accepted accounting principles (“GAAP”). There is no corresponding “GAAP” requirement set forth in the UFOC Guidelines for Item 19.

Franchisors’ Item 19 disclosures regarding the historical financial performance of their franchisees are, by necessity, based on reports received from their franchisees - - reports that are rarely prepared on a GAAP basis. Few, if any, franchisors are likely to require their franchisees to submit audited financial statements in order that the franchisor can prepare a financial performance representation in accordance with footnote 293. And few of the UFOC Item 19 financial performance disclosures extant today could meet the standard required by footnote 293. Because this requirement will result in a decrease in the number of franchisors providing such information, we respectfully request that the FTC delete footnote 293.

J. Item 20: Outlets and Franchisee Information (Rule §436.5[t])

1. Tabular Information Regarding Franchised Outlets

The FTC’s proposal goes a long way to resolving the double counting problem inherent in Item 20 in an altogether sensible fashion. This is a laudable goal inasmuch as elimination of double counting would allow for precise calculation of system turnover rates - - information which can be revealing about the state of franchise systems. A certain amount of confusion remains, however, because the first table combines two very different types of events - - i.e., those involving ownership of the franchise (changes affecting the franchisee) and those involving discontinuation of the location (changes affecting the franchised unit).

The problems posed by the proposed revision to Item 20 is most apparent in the situation where a franchisor, after having notified a franchisee of its unconditional intent to exercise its right to terminate (or, alternatively, to not renew) the franchise, permits the franchisee to transfer the franchise. First, we note that application of the “first-in-time” principle in these circumstances - - which would compel disclosure of the event solely as a termination (or non-renewal) - - may suggest erroneously that the franchisee was unable to recoup any of its investment.

Second, since ownership of the franchise was transferred and operation of the franchised unit - - despite the termination - - was <u>not</u> discontinued, there is no way to properly account for these events under Item 20 such that “[t]he sum of columns (3) and (9) ... equal[s] the number of outlets at the beginning of the fiscal year (column 2)” (proposed Rule §435.6[t][1][xi]). This instruction presupposes a direct, one-to-one relationship between events affecting the franchisee and events affecting the franchised unit. However, in this instance, where a transferee maintains operation of the franchise, the internal consistency required by the instruction cannot be achieved because the events (i.e., termination <u>and</u> <u>transfer</u>) have not affected the number of operational franchised units. For this reason, NFC recommends that the above-quoted instruction be deleted.

While it is possible to obtain internal consistency that would allow for the cross-tabulation contemplated by the proposed instruction, this could only be accomplished by adding new disclosure categories and expanding the tabular presentation of such data. If the FTC is determined to achieve this objective despite the added complexity and compliance burden for franchisors, the NFC strongly recommends that the FTC give consideration to the proposal developed by the North American Securities Administrators Association’s Franchise and Business Opportunities Project Group.

Finally, we note that definition of “transfer” (proposed Rule §435.6[t][1][vi]), which references “one or more new owners”, should be revised to include “one or more new <u>or</u> <u>different</u> owners” to account for a transfer to an existing franchisee in the system.

2. Franchisee Associations

While the NFC recognizes that value of requiring disclosure of those franchisee associations that franchisors support or recognize, we believe that provisions requiring disclosure of other associations will have unintended consequences damaging to franchise systems.

The proposed requirement that such other groups incorporate and formally request inclusion in franchisors’ offering circulars will not serve as a meaningful screening mechanism. Isolated, <u>ad</u> <u>hoc</u> rump groups will obtain incorporation for the sole purpose of gaining disclosure in the franchisor’s offering circular. Indeed, under the FTC’s proposal, a single person with an ax to grind - - whether or not either a current or former franchisee - - could incorporate and gain inclusion in the franchisor’s offering circular. We respectfully submit that this proposal is unfairly prejudicial to franchisors and will mislead prospective franchisees.

Item 20 already guides prospective franchisees as to how they can determine the state of franchise relations in the system - - including a listing of the names and telephone numbers of all franchisees that left the system during the previous fiscal year. 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. Should the FTC, nonetheless, retain this provision, it will be incumbent upon it to develop a workable mechanism to certify that the franchise group actually represents a significant percentage (which, we suggest, should be at least 20%) of the system's franchisees.

3. "Gag Clauses"

The NFC believes that the phrase "gag clause" is a pejorative term which should be replaced with the phrase "confidentiality agreement".

Further, the NFC strongly urges the Commission to limit disclosure of such confidentiality agreements to instances where either all franchisees, or at least twenty percent of the franchisee population, is barred from communicating with third parties (including, naturally, prospective franchisees of the subject franchise system) regarding their experience as franchisees, whether pursuant to the subject franchise agreement; any related agreement; or, otherwise.

For these reasons, the NFC respectfully submits that the Commission revise proposed Rule §436.5(t)(6) such that only a franchisor's universal practice of requiring confidentiality agreements from its franchisees (whether in franchise agreements, related agreements or otherwise), or instances where 20% or more of a franchisor's franchisee population is subject to such confidentiality agreements - - in both instances exclusive of litigation and other dispute settlements - - be required.

K. Item 21: Financial Statements (Rule §436.5[u])

Foreign franchisors and their corporate parents often do not compile their audited financial statements in accordance with United States generally accepted accounting principles ("GAAP"). In such instances, conversion to GAAP financial statements would take an extraordinarily long period of time and can be accomplished only at great expense, virtually suspending such a foreign franchisor's franchising abilities for inordinate periods of time. Further, as the Commission knows, no corollary requirement may be found in the UFOC Guidelines governing Item 21.

Accordingly, the NFC respectfully requests that the requirement contained in Disclosure Item 21(1) pertaining to GAAP financial statements be excised from the final Rule.

(The NFC's strong objection to including the financial statements of a franchisors parent in that franchisor's disclosure document is set forth above in Section

IV[C] of this comment letter at pages 5-10).

L. Item 23: Receipt (Rule §436.5[w])

The NFC believes that the Disclosure Item 23 receipt form may more clearly reflect the Rule's requirements if the following sentence is revised as suggested below (modifications are redlined):

> You must also receive a franchise agreement ~~containing all material terms~~ <u>in a form ready for execution</u> at least five days before you sign a franchise agreement.

Further, the requirement set forth in Disclosure Item 23(2) - - that a franchisor obtained a disclosure document receipt at least five days before executing a franchise agreement with a prospective franchisee or receiving money from it - - is, it is respectfully submitted, burdensome and wholly unnecessary. In reality, after furnishing a disclosure document to a prospective franchisee, the communications between them are routinely conducted telephonically or electronically - - rarely in person. Following disclosure, frequently the next time the parties meet in person is when the subject franchise agreement is executed (and perhaps not even then). Requiring franchisors to obtain from all of their prospective franchisees the Disclosure Item 23 receipt five days before the subject franchise agreement is signed or the prospective franchisee pays any fee is extraordinarily burdensome, requiring a franchisor to compel franchisee conduct before a relationship between them is even formalized. And, we respectfully submit, it does not provide any benefit to franchisees - - the only reason franchisors are compelled to obtain and retain Item 23 receipts from their franchisees is so that they can demonstrate compliance with federal and state disclosure requirements at a subsequent time. It is thus irrelevant when the franchisor receives the receipt, so long as the date set forth therein indicates precisely when the prospective franchisee received the franchisor's disclosure document. Frankly, if this provision is intended to discourage the "backdating" of Item 23 receipts, the Commission should have no concern - - such wrongful conduct can transpire at any time and under any circumstance - - including under this Rule provision - - but should it occur, the subject franchisee will always be able to make clear what happened in complaints to the Commission, the franchise-regulating states and in private actions.

M. Section 436.9: Exemptions

The NFC's extensive comments on this proposed Rule provision are set forth above at Section IV(I) of this comment letter (<u>supra</u> at pages 17-23).

* * * * * *

As noted at the outset of this comment letter, the NFC and its members are indebted to the Commission for promulgating an NPR and a proposed revised FTC Franchise Rule of remarkable intelligence, foresight and sophistication.

We also greatly appreciate the Commission's granting an opportunity to all concerned parties, including the NFC, to have an opportunity to comment on the proposed revised Rule prior to its final promulgation. The NFC stands ready to assist the FTC in any fashion desired as it moves toward final promulgation of the revised Rule.

Respectfully submitted,

NATIONAL FRANCHISE COUNCIL

/s/ ____________________________
MORTON H. ARONSON
Chairman

/s/ ____________________________
NEIL A. SIMON
Executive Director

/s/ ____________________________
DAVID J. KAUFMANN
Counsel