Washington, DC

December 22, 1999

Secretary
Federal Trade Commission
Room 159
600 Pennsylvania Avenue, NW
Washington, DC 20580

Re: "16 CFR Part 436-Franchise Rule Comment"

Dear Secretary:

We enclose a paper copy of initial comments on the FTC's proposed revisions to "16 CFR Part 436-Franchise Rule." We also e-mailed the comments to FRANPR@ftc.gov today.

The comments have been prepared by Warren L. Lewis of Lewis & Kolton, PLLC, and are supported by the following franchisor and subfranchisor companies and organizations:

Aire Serve Heating & Air Conditioning, Inc.
Blimpie International, Inc.
CGI Franchise Systems, Inc. *dba* Worldwide Express
CleanNet USA, Inc.
Commission Express National, Inc.
Dairy Queen Territory Operators Organization
Dreammaker Bath & Kitchen by Worldwide
Glass Doctor
Interstate Dairy Queen Corporation
Mr. Appliance Corp.
Mr. Electric Corp.
Mr. Rooter Corporation
NaturaLawn of America, Inc.
Postal Annex+, Inc.
Rainbow International Carpet Dyeing & Cleaning Co.
Stuckey's Corporation
Sureway Air Traffic Corporation *dba* Sureway Worldwide
Swisher Hygiene Franchise Corp.

The Dwyer Group, Inc.
Val-Pak Direct Marketing Systems, Inc.
WOW Development Corporation *dba* Wonders of Wisdom

Sincerely,

Warren L. Lewis

Enclosure
FTC-000-01

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Washington, DC

# INITIAL COMMENTS
# TO THE
# FEDERAL TRADE COMMISSION
# ON
# "16 CFR PART 436 – FRANCHISE RULE"

**December 22, 1999**

**Prepared**
**by**
**Warren L. Lewis, Esquire**
**Lewis & Kolton, PLLC**

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**TO THE**
**FEDERAL TRADE COMMISSION**
**ON**
**"16 CFR PART 436 – FRANCHISE RULE"**

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**INITIAL COMMENTS TO THE FEDERAL TRADE COMMISSION ON "16 CFR PART 436 – FRANCHISE RULE"**

## A. Introduction

Warren L. Lewis, Esquire, of Lewis & Kolton, PLLC, and the companies and organizations identified on the cover page ("we") submit these initial comments to the Federal Trade Commission ("you") on the proposed revisions to "16 CFR Part 436 – Franchise Rule" (the "rule").

We support your effort to update and revise the rule. Our initial comments on your proposed revisions are summarized below in Section B and more fully explained below in Section C.

## B. Summary of Comments

In summary, we recommend that you:

1. revise your definition of the term *action*;
2. define the term *broker*;
3. revise your definition of the term *franchise seller*;
4. revise your definition of the term *franchisor*;
5. use a more neutral term than *gag clause*;
6. define the term *parent*;
7. revise your definition of the term *person*;
8. revise your definition of the term *predecessor*;
9. define the term *subfranchisor*;
10. change some of the Item titles in the Table of Contents;
11. revise the title of Item 1;
12. not require a parent's directors, officers and similar persons to be disclosed in Item 2;
13. (a) not require pending actions involving the franchise relationship to be

disclosed in Item 3, or require pending actions to be disclosed only if they exceed a minimum number or percentage;

(b) not require past actions to be disclosed if they were voluntarily dismissed or settled favorably to a franchisor or subfranchisor;

14. revise the title and other language in Item 5;

15. revise the title and other language in Item 6;

16. not require Item 7 disclosures to be tied to a franchisee's "likely operational costs" or "break even" point;

17. not require a franchisor or subfranchisor to disclose its "current development plans" in Item 12;

18. not require all data supporting Item 19 representations to be prepared according to U.S. generally accepted accounting principles;

19. (a) require or permit state-by-state franchise sales and outlet openings to be disclosed in Item 20;

(b) permit franchisee and outlet names, addresses and telephone numbers to be disclosed in Item 20 as of a franchisor's or subfranchisor's last fiscal year end;

(c) permit non-communicating franchisees' names, addresses and telephone numbers to be disclosed in Item 20 for the 10-week period before a franchisor's or subfranchisor's last fiscal year end;

(d) use a more neutral term than "gag order" in Item 20;

20. (a) in Item 21, permit non-U.S. franchisors and subfranchisors to use financial statements prepared according to their own countries' GAAPs;

(b) require a subfranchisor's financial statements to be included in Item 21 only if the subfranchisor will be assuming the franchisor obligations to the franchisee under the franchise agreement;

(c) require a parent to include its financial statements in Item 21 only if the parent chooses to guarantee the franchisor obligations to the franchisee under the franchise agreement;

(d) clarify the language in the chart in Item 21 for start-up franchisors;

21. require 2 receipts in Item 23, and permit “prospective franchisees” to sign

the receipts as such, rather than as “franchisees”;

22. permit a franchisor or subfranchisor to include explanatory or supplemental information in a disclosure document that may not be required or permitted by federal or state law;

23. increase the 90-day deadline for updating a disclosure document after fiscal year end to a fairer and more realistic 120-day deadline;

24. increase the $500 minimum required payment threshold for the rule to at least $2,500;

25. permit a franchisee to initial changes to a franchise agreement when he or she signs the contract, and permit a franchisor or subfranchisor to make additional changes to a franchise agreement during the final 5-day waiting period, if the additional changes are requested by and benefit the franchisee or directly relate to those additional changes; and

26. not require a franchisor or subfranchisor to include its attorneys’ and consultants’ names, addresses and telephone numbers in its disclosure document.

**C. <u>Comments</u>**

_____ 1. §436.1(a) – *Action*

We recommend that the word "served" be inserted after the word "complaints" in the definition of the term *action*. This would make it clear that a franchisor or subfranchisor would not be required to disclose an *action* until it is served with a triggering complaint or claim in the *action*.

Sometimes, an adverse party (including possibly a current or former franchisee) may file a complaint or claim against a franchisor or subfranchisor, but may never serve the franchisor or subfranchisor with the complaint or claim. The franchisor or subfranchisor may or may not know that a complaint or claim has been filed. In this situation, the franchisor or subfranchisor should not be required to disclose information about the complaint or claim until it has been served.

_____ 2. §436.1 – *Broker*

You do not propose to define the term *broker*.

We recommend that you define the term *broker* as follows:

“*Broker* means any person who engages in the business of representing a franchisor or subfranchisor in offering for sale or selling a franchise and who is not a franchisor or

subfranchisor, or an officer, director or employee of a franchisor or subfranchisor, with respect to such franchise. It does not include a franchisee merely because the franchisee receives a payment from the franchisor or subfranchisor in consideration of the referral of a prospective franchisee to the franchisor or subfranchisor, if the franchisee does not otherwise participate in the sale of the franchise to the prospective franchisee. A franchisee does not participate in the sale of a franchise merely by participating in initial conversations or communications with a prospective franchisee about a franchise."

This definition is modeled on the definition of *franchise broker* in Section 3(21) of the Illinois Franchise Disclosure Act. The definition refers to subfranchisors (which the Illinois definition does not), provides latitude for franchisees to participate in referral programs without becoming brokers (with more liberal language than is in the Illinois definition), and follows the format of your other definitions. Other state franchise disclosure laws and regulations also contain *broker* definitions, but those definitions are less comprehensive than the Illinois definition (see Hawaii Franchise Investment Law, §482E-2, *franchise broker or selling agent*; New York Franchises Law, §681.8, *franchise sales agent*; Virginia Retail Franchising Act, §5-110-10 of regulations, *franchise broker*; and Washington Franchise Investment Protection Act, §19.100.010(11), *franchise broker*).

The definition is necessary, because you will be requiring *broker* disclosures in Items 2, 3 and 4 of a franchisor's or subfranchisor's disclosure document, because the term *broker* can have many different meanings (as shown by the different definitions in existing state franchise disclosure laws), and because franchisees who participate in franchisors' referral programs (which are common in the franchise industry) generally should not be deemed to be brokers.

_____ 3. §436.1(h) – *Franchise Seller*

We recommend that you revise the 2nd sentence in the *franchise seller* definition to state as follows:

> "It includes the franchisor or subfranchisor, and its employees, representatives, agents and brokers, unless the franchisor or subfranchisor has, and is exercising, a right to approve or disapprove a franchisee's sale or transfer of its own outlet to another person and is not otherwise significantly involved in the sale or transfer."

This recommended language incorporates 3 changes. First, the words "the franchisor" have been changed to "the franchisor or subfranchisor", because either a franchisor or a subfranchisor may offer or sell a franchise. Second, the words "third-party brokers" have been changed to "brokers", in conjunction with including a *broker* definition in the rule. With *broker* defined, the words "third-party" are unnecessary. Third, the clause starting with "unless" has been added to clarify that a franchisor or subfranchisor generally is not a *franchise seller* when a franchisee is selling or transferring its own outlet. The language in the clause is consistent with the language in the last paragraph in Part I.B.2 of your Interpretive Guides.

_____ 4. §436.1(j) – *Franchisor*

We recommend that you add the following sentence to the definition of the term *franchisor*:

"It includes a subfranchisor unless otherwise stated."

This recommended addition is modeled on similar language in §3(3) of the Illinois Franchise Disclosure Act and §31010 of the California Franchise Investment Law.

_____ 5. §436.1(k) – *Gag Clause*

You propose to define the term *gag clause*.

We recommend that you change the term "*gag clause*" to a more neutral term, such as "*confidentiality clause*" or "*nondisclosure clause*."

The word "gag" is negative and inappropriate in most instances. No one likes to "gag." Also, hopefully, most franchisees who enter into contracts containing confidentiality or nondisclosure clauses do not feel that they are being "gagged," even though they may be restricted or prohibited from discussing aspects of their experience as a franchisee in a particular franchise system.

_____ 6. §436.1 – *Parent*

You do not propose to define the term *parent*.

If you adopt some or all of your proposed *parent* disclosure requirements, we recommend that you define the term *parent* as follows:

"*Parent* means an entity that directly or indirectly has an 80% or greater ownership interest in the franchisor."

Without a definition, it is unclear whether an entity must have an 80%, 100% or other minimum percentage ownership interest in the franchisor, or whether it must have a direct ownership interest in the franchisor, to be a *parent*.

We are not aware of any definitions of the term *parent* in any state franchise disclosure laws.

_____ 7. §436.1(p) – *Person*

We recommend that you change "other business entity" to "other entity," and add the following sentence to the definition of the term *person*:

"An individual is not an entity."

These changes will make it clear throughout the rule that: when you use *person*, you mean an individual or a business entity; and that when you use *entity*, you mean only a business entity.

_____ 8. §436.1(r) – *Predecessor*

You propose to include within the definition of the term *predecessor*, "a person . . . from whom the franchisor obtained a license to use the trademark or trade secrets in the franchise operation."

We recommend that you do not define this type of person as a *predecessor*, or at a minimum, that you add the word "principal" in front of the word "trademark" and also in front of the words "trade secrets."

If a franchisor is the licensee under a trademark or trade secret license that is potentially significant to a prospective franchisee, information about that license will be disclosed in Item 12 or 13 of the franchisor's disclosure document. Therefore, it is not necessary for you to define a trademark or trade secret licensor as a *predecessor* in order to cause a prospective franchisee to know about the licensing relationship.

Also, franchisors and subfranchisors already have difficulty obtaining accurate and complete disclosure information on traditionally-defined *predecessors* (i.e., persons from whom they have acquired the major portion of their assets). Obtaining accurate and complete information on this new proposed class of *predecessors*, licensors, would be equally or even more difficult, but would not result in the disclosure of significant new information to prospective franchisees.

_____ 9. §436.1 – Subfranchisor

You do not propose to define the term *subfranchisor*.

We recommend that you define the term *subfranchisor* as follows:

"*Subfranchisor* means any person who has an agreement with a franchisor whereby the person has been granted the right, in consideration for a payment to the franchisor or a person affiliated with the franchisor in whole or in part for that right, to sell or negotiate the sale of franchises, or to service franchises, using the trademark of the franchisor or on behalf of the franchisor. An agreement that is a franchise does not become a subfranchise merely because under its terms a person is granted the right to receive compensation for making referrals to a franchisor or compensation for acting as a sales representative on behalf of a franchisor.

This definition is modeled on the *subfranchise* and *subfranchisor* definitions in §31008.5 and §31009 of the California Franchise Investment Law and §705/3 (4) – (5) of the Illinois Franchise Disclosure Act.

Other state franchise disclosure laws and regulations also contain *subfranchisor*-

related definitions (see Hawaii Franchise Investment Law, §482E-2, *area franchise* and *subfranchisor*; Maryland Franchise Registration and Disclosure Law, §14-201(c) and (i), *area franchise* and *subfranchisor*; Minnesota Franchises Act, §80C.01, Subds. 7 and 8, *area franchise* and *subfranchisor*; New York Franchises Act, §681.1, *area franchise* and *subfranchisor*; North Dakota Franchise Investment Law, §51-19-02(2) and (16), *area franchise* and *subfranchisor*; Rhode Island Franchise Investment Act, §19-28.1-3(m) and (n), *master franchise* and *subfranchisor*; South Dakota Franchises Law, §37-5A-5(3) and (14), *area franchise* and *subfranchisor*; Virginia Retail Franchising Act, §13.1-559(e), *subfranchisor*; Washington Franchise Investment Protection Act, §19.100.010(9) and (10), *subfranchise* and *subfranchisor*).

The definition is necessary, because you will be requiring extensive *subfranchisor* disclosures throughout a disclosure document, and because the term *subfranchisor* can have many different meanings (as shown by the different definitions in existing state franchise disclosure laws).

Who is or is not a subfranchisor often is not a simple determination. Franchisors and state examiners often become involved in disputes about whether particular persons are or are not *subfranchisors*. The rule should contain a definition of the term *subfranchisor* to help persons who might be regulated to determine their status with greater certainty.

_____ 10. §436.4 – Table of Contents

We recommend that you change the title of Item 5 from "Initial Franchise Fee" to "Initial Fees," so that the title will more accurately describe what is in the Item.

We recommend that you change the title of Item 23 from "Receipt" to "Receipts." This change ties into our later recommendation that 2 receipts (1 for the franchisee and 1 for the franchisor) be included in Item 23, consistent with current UFOC requirements and industry practice.

_____ 11. §436.5(a) – Item 1

We recommend that "Parents" be changed to "Parent" in the title of Item 1, to make the title consistent with the Table of Contents in §436.4.

_____ 12. §436.5(b) – Item 2

You propose to require a franchisor or subfranchisor to disclose the names and employment histories of any parent's "directors, trustees, general partners, [or] officers . . . who will have management responsibility relating to the offered franchises."

We recommend that you not adopt this requirement, or that you modify the requirement to more clearly define when the director, trustee, general partner or officer of a parent is covered by the rule.

Under the current UFOC guidelines, franchisors and subfranchisors must disclose

information in Item 2 about their directors, trustees, general partners, principal officers and other executives "who will have management responsibility relating to the franchises offered." Although the quoted language is intended to be limiting, as a practical matter, since all directors, officers and similar executives of a franchisor or subfranchisor arguably have at least some "management responsibility" relating to franchises offered by their company, most franchisors and subfranchisors end up disclosing information in Item 2 on all directors, officers and similar executives.

You now propose to require the disclosure of information in Item 2 about the directors, officers and similar executives of a parent, subject to the same limiting language. The likely impact of this proposed requirement, if adopted, would be to cause many franchisors and subfranchisors with parents to disclose information on all of their parents' directors, officers and similar executives, since all of those persons at least arguably have management responsibility relating to franchises offered by their companies' subsidiaries. This would clutter their Item 2s with information of marginal relevance and importance to prospective franchisees. Although the benefits to prospective franchisees would be minimal, the burdens on the franchisors and subfranchisors of compiling information on all of these persons (including information about their litigation and bankruptcy histories for Items 3 and 4), would be significant.

13. §436.5(c) – Item 3

a. Pending Actions Involving Franchise Relationship

In §436.5(c)(1)(ii), you propose to require a franchisor or subfranchisor to disclose "any pending material civil action involving the franchise relationship."

We recommend that you not adopt this requirement, or at a minimum, that you impose the requirement only if the number of pending actions without counterclaims of fraud, etc., is 4 or more, or involves 5% or more of the franchisor's or subfranchisor's total number of franchisees, whichever is greater.

Franchisors and subfranchisors sometimes need to bring actions against franchisees to collect royalties or other amounts due, or to enforce system standards. They are already inhibited significantly in this regard, because if their actions prompt counterclaims of fraud, etc., they must amend their disclosure documents in order to continue selling franchises.

You now propose to require franchisors and subfranchisors to amend their disclosure documents and disrupt their franchise sales every time they bring an action against a franchisee relating to the "franchise relationship," even though the franchisee may have no counterclaim for fraud, etc. This requirement is unfair and burdensome, and should not be adopted.

If you are concerned that prospective franchisees should know about particular franchisors or subfranchisors that are highly litigious, even though their franchisees are not, there should be a minimum threshold before disclosure is required. As stated above, we recommend that the minimum be 4 pending actions without counterclaims of fraud, etc., or pending actions

without counterclaims of fraud, etc. involving 5% or more of the franchisees in a system, whichever is greater. This minimum would allow non-litigious franchisors and subfranchisors to bring actions when necessary without having to amend their disclosure documents in each instance, but would be low enough to reveal highly litigious franchisors and subfranchisors.

b. Voluntarily Dismissed or Settled Actions

In §436.5(c)(1)(iii)(c) and footnote 282, you propose to require a franchisor or subfranchisor to disclose a past material action even if it was settled favorably to the franchisor.

We recommend that you not adopt this requirement.

Under current UFOC guidelines, a franchisor or subfranchisor may omit a past action from Item 3 if it was settled without the franchisor or subfranchisor agreeing to pay material consideration or agreeing to be bound by obligations which were materially adverse to its interests, and a franchisor or subfranchisor also may omit a past action from Item 3 if it was dismissed by final judgment without liability of or entry of an adverse order.

You now propose to require a franchisor or subfranchisor to continue to disclose any past action that was dismissed "in connection with a settlement," even if that settlement was favorable to the franchisor or subfranchisor. On the other hand, you propose to continue the policy of permitting a franchisor or subfranchisor to stop disclosing an action that was dismissed "by final judgment without liability or entry of an adverse order."

We oppose your proposal concerning settled actions, because we believe that parties should be encouraged to settle, and should not be penalized when they do so. Your proposal would penalize franchisors or subfranchisors who achieve favorable settlements, since they would be required to continue to disclose the settled actions. We recommend that you adopt the current UFOC guideline policy of permitting a franchisor or subfranchisor to stop disclosing an action that was settled, if the franchisor or subfranchisor does not agree to pay material consideration or agree to be bound by obligations which are materially adverse to its interests.

14. §436.5(e) – Item 5

We recommend that you change the title of Item 5 from "Initial Franchise Fee" to "Initial Fees," to more accurately describe what is in the Item.

For internal consistency, we also recommend: that "initial franchise fee" be changed to "initial fees" and "this fee is refundable" be changed to "these fees are refundable" in the 1st sentence; that "initial fee is" be changed to "initial fees are" in the 2nd sentence; and that "'initial fee' means" be changed to '"initial fees' mean" in the 3rd sentence.

15. §436.5(f) – Item 6

We recommend that you change the title of Item 6 from "Recurring or Occasional Fees" to "Other Fees," to match the title of Item 6 in the Table of Contents in §436.4.

We also recommend that you insert the punctuation and words ", other than initial fees," after the words "any recurring or occasional fees" in the 1st sentence.

16. §436.5(g) – Item 7

You state in the commentary to Item 7 (at p. 31) that information provided by a franchisor or subfranchisor in Item 7 will "assist prospective franchisees to understand not only the costs of entering into the business, but their likely operational costs until they can break even."

We recommend that you delete this statement from the commentary and this concept from the rule.

Consistent with current UFOC guidelines, your proposed title for Item 7 is "Estimated Initial Investment." Also consistent with current UFOC guidelines, you propose to require the disclosure in Item 7 of specific pre-opening and start-up expenditures such as the initial franchise fee, training expenses, real property expenses, equipment and fixture expenses, initial inventory costs, security deposits, etc., and of an "other payments" category for "any other miscellaneous expenses that the franchisee will incur before operations begin and during the initial phase" of the franchised business.

We have no objection to these requirements, but we oppose your interpretation of them in your discussion of Item 7 as requiring the disclosure of franchisees' "likely operational costs until they can break even." Franchisor and subfranchisors have never been required to project franchisees' "likely operational costs" or "break even" points, in either Item 7 or Item 19. This should not be made a requirement, since projections are inherently unreliable but can be viewed by prospective franchisees as guarantees or implied earnings claims, and since franchisees' operational costs are highly variable, depending in large part on factors that are beyond franchisors' and subfranchisors' control (including, in particular, franchisees' own decisions about what costs to incur in the operation of their businesses).

17. §436.5(l) – Item 12

You have asked (at p. 95) whether you should require a franchisor or subfranchisor to disclose its "current development plans" in Item 12.

We recommend that you not impose this requirement.

A franchisor's or subfranchisor's "current development plans" are proprietary or at least closely held (if not technically proprietary), and by their nature, are constantly changing. They are also, by their nature, merely "plans" that may or may not be pursued.

While franchisors and subfranchisors should be required to disclose their current and past territorial practices, they should not be required to disclose their proprietary (or at least closely held) and constantly changing plans about possible future expansion.

_____ 18. §436.5(s) – Item 19

In footnote 293, you state that any "historical data [used to support a representation or forecast in Item 19] must be prepared according to U.S. generally accepted accounting principles."

We recommend that you not impose this requirement, or that you modify this requirement to permit a representation or forecast to be based on data prepared according to U.S. generally accepted accounting principles ("GAAP") or on data that the franchisor or subfranchisor reasonably believes to be reliable.

Of the 20% or so of franchisors and subfranchisors that make Item 19 representations, many rely on sales or cost data received from franchisees, or on sales or cost data from the operation of their own or affiliates' outlets. This may be the only data available to them. Even if this data is not prepared according to strict U.S. GAAP (which is probably the case in most instances), the franchisors and subfranchisors should be permitted to rely on it if they reasonably believe it to be reliable.

_____ 19. §436.5(t) – Item 20

a. Franchise Sales and Outlet Openings

We recommend that you require or permit franchise sales and outlet openings to be disclosed in the Item 20(1) table (for franchised outlets). This information is extremely important to prospective franchisees, and is helpful to them in understanding the other information required to be disclosed in the table (outlets open, outlets transferred, outlets discontinued, etc.).

We are not proposing a specific revised format for the franchised outlet table in these initial comments, because we understand that others will be making detailed proposals. We may submit rebuttal comments on those proposals. We note, however, that the currently proposed format would make the franchised outlet and franchisor-owned outlet tables about 4 to 5 times longer than they currently are, since each state would require 4-5 lines (i.e., 1 line for the state abbreviation, possibly 1 line for a space, and 3 lines for the years), rather than just 1 line. This would increase the length of a typical Item 20 to at least 10 to 15 pages, which would be cumbersome and possibly intimidating to many prospective franchisees.

b. Current Franchisees or Franchised Outlets

In §436.5(4), you propose to require a franchisor or subfranchisor to disclose the names, addresses and telephone numbers of "all current franchisees," or alternatively, to disclose franchised outlets in certain circumstances.

We recommend that you permit franchisee and franchised outlet disclosures to be made "as of the end of the most recently completed fiscal year or as of the disclosure document issuance date."

Administratively, it is most efficient for a franchisor or subfranchisor to compile franchisee, outlet and other franchise system information for each fiscal year, or as of each fiscal year end. Interim compilations generally are burdensome, costly and prone to error. Also, it is impractical, and financially prohibitive because of state registration amendment requirements, to constantly update franchisee, outlet and similar information in a disclosure document during a fiscal year. These realities are at least impliedly recognized in most parts of the rule. They should be recognized here.

If a franchisor or subfranchisor is able to provide a current franchisee or outlet list in its disclosure document, it should be permitted to do so. However, it should only be required to provide a list as of the end of its most recent fiscal year.

c. Franchisees Not Communicating with Franchisor

In §436.5(t)(5), you propose to require a franchisor or subfranchisor to disclose "the name and last known home address and telephone number of every franchisee…who has not communicated with the franchisor [or subfranchisor] within 10 weeks of the disclosure document issuance date."

For the same reasons as stated in 19.b above, we recommend that you require these disclosures for every franchisee who has not communicated with the franchisor or subfranchisor within 10 weeks of "the end of the most recently completed fiscal year or the disclosure document issuance date."

d. Gag Clauses

We recommend that the term "gag clauses" used in § 436.5(t)(6) be changed to a more neutral term, such as “confidentiality clauses” or “nondisclosure clauses,” consistent with our comment on §436.1(k).

_____ 20. §436.5(u) – Item 21

a. Financial Statements According to U.S. GAAP

We recommend that you change the words "generally accepted United States accounting principles" in §436.5(u)(1) to the words "U.S. generally accepted accounting principles," for consistency with the wording in §436.5(s), and that you adopt this requirement only for U.S.-based franchisors and subfranchisors. Non-U.S. franchisors and subfranchisors should be permitted to use financial statements prepared according to their countries’ GAAPs as long as those GAAPs are comparable to U.S. GAAP.

b. Financial Statements For a Subfranchisor

In §436.5(u)(iii)(B), you propose to require any subfranchisor’s financial statements to be included in Item 21.

We recommend that you modify this proposal to require the inclusion of a subfranchisor's financial statements if the subfranchisor (rather than the franchisor) will be the party assuming the franchisor obligations to the franchisee under the franchise agreement, and to merely permit inclusion of a subfranchisor's financial statements if the franchisor (rather than the subfranchisor) will be the party assuming the franchisor obligations to the franchisee under the franchise agreement.

c. Financial Statements for a Company With 80% or More Control

In §436.5(u)(iii)(C), you propose to require a franchisor or subfranchisor to include in Item 21, the financial statements for any company with an 80% or more controlling interest in the franchisor or subfranchisor.

We recommend that you adopt this requirement only if (i) the company with the control chooses to guarantee the obligations of the franchisor or subfranchisor to the franchisee in writing, and (ii) a copy of the written guarantee is included in Item 21 or an exhibit.

A company's financial statements should be included in Item 21 only if it is the franchisor, or is another company that will have contractual obligations to the franchisee, such as a subfranchisor or guarantor. Including any other company's financial statements in Item 21 is likely to be unfair and misleading to a prospective franchisee, since he or she may rely on the financial statements (particularly if they are strong) without realizing that the company will have no contractual obligations to the prospective franchisee.

The current UFOC guidelines permit states to require franchisors and subfranchisors to include their parents' and affiliates' financial statements in Item 21, but by practice and regulation, the states have permitted or required those financial statements to be included only when guarantees or surety bonds have been provided (see, e.g., Minnesota regulations §2860.1600; New York regulations, §2004.4, Item 21, B). We urge you to adopt the same approach.

d. Financial Statements For Start-Up Franchisors

We recommend that you change the words "the last fiscal year" in the 3rd right box in the §436.5(u)(2) chart to the words "the first partial or full fiscal year selling franchises." This will clarify what we believe you intend.

21. §436.5(w) – Item 23

We recommend that you change the title of Item 23 from "Receipt" to "Receipts," and that you change the words "acknowledgment of receipt" in §436.5(w)(1) to the word "receipts." These changes will conform the rule to current industry practice, which is to have 2 receipts at the end of the disclosure document (1 for the franchisee and 1 for the franchisor).

We also recommend that you change the words "franchisee's signature" in §436.5(w)(1)(vii) to the words "prospective franchisee's signature." Some prospective franchisees

object to signing receipts as "franchisees," since this designation is inaccurate until they have signed franchise agreements. As a result, many franchisors have converted to using "prospective franchisee" signature lines on their receipts, rather than "franchisee" signature lines. We recommend that you adopt this approach.

22. §436.6 (c) – Instructions for Preparing Disclosure Documents

You propose to prohibit a franchisor or subfranchisor from including in its disclosure document "any materials or information other than that required by this Rule or by State law not preempted by this Rule."

First, to more accurately reflect your intent, we believe that the words "or permitted" should be inserted after the word "required" in the proposed language. This is because the rule "permits" rather than "requires" some information to be in a disclosure document (such as the reasons for purchase obligation requirements, the circumstances under which franchisee confidentiality clauses were signed, etc.).

Second, although we understand the purpose for the proposed language, we believe that the prohibition creates an unfair trap for franchisors and subfranchisors, and is unnecessarily rigid. We understand that your purpose is to prevent a disclosure document from being cluttered with unnecessary information that might make it difficult for a prospect to find, or that might divert a prospect's attention away from, required or permitted information. We do not disagree with this purpose. Instead, we note that a franchisor or subfranchisor sometimes needs to include information in a disclosure document that it believes is material or possibly material (even though the information is not required or permitted under federal or state law) or that it believes will help a prospect to better understand required information or its significance. Providing supplementary or explanatory information of this type should not be a rule violation, unless the information is excessive, misleading or intentionally diversionary.

Under current industry practice, many franchisors and subfranchisors include supplementary or explanatory information in their disclosure documents. They are restrained in this area by state franchise administrators who do not permit excessive extra information (such as excessive puffing language) to be included in disclosure documents, by the reality that cluttering a disclosure document with extra information seldom is likely to be helpful in making franchise sales, and by the concern that legal liability might arise if it could be shown that a franchisor or subfranchisor has tried to mislead or confuse prospects with extra information.

23. §436.8 – Instructions For Updating Disclosures

You propose to continue to require a franchisor or subfranchisor to prepare a revised disclosure document within 90 days after the close of each fiscal year, "after which the franchisor [or subfranchisor] may distribute only the revised document and no other."

We recommend that you give a franchisor or subfranchisor 120 days after the close of each fiscal year to prepare a revised document.

Your 90-day deadline is burdensome for many franchisors and subfranchisors, because they often find it difficult to obtain audited financials from accountants within 90 days after fiscal year end – particularly if they are small, privately-held companies, and particularly if their fiscal year end is December 31.

Your 90-day deadline also weighs most heavily on smaller or regional franchisors and subfranchisors that do not have registered disclosure documents. This is because you relax the 90-day deadline (which you should) for franchisors and subfranchisors that have state disclosure document registrations. Those registrations generally last until at least 110 or 120 days after fiscal year end (see Attachment C) or for a full year irrespective of fiscal year end. Since you permit those franchisors and subfranchisors to continue to use unrevised disclosure documents after the 90-day deadline if the documents are based on registered documents still in effect (Interpretive Guidelines, Part I.D.1), franchisors and subfranchisors with registered documents can continue to offer and sell franchises even if they don't yet have new audited financial statements. This option is not available to franchisors and subfranchisors that do not have registered documents.

Your 90-day deadline should be changed to a 120-day deadline, to be fairer to smaller and regional franchisors and subfranchisors, to establish a more realistic federal deadline, and to bring the rule more into line with the 120-day deadline used by most fiscal year end state franchise laws (see Attachment C).

_____ 24. §436.9 – Exemptions

In §436.9(a), you propose to continue to use the $500 minimum required payment threshold for the rule.

We recommend that the minimum threshold be significantly higher (at least $2,500) and be reviewed every 4 years (similar to the initial investment and net worth thresholds proposed in §436.9(e)).

The $500 threshold was established 20 years ago, in 1979. From 1979 to 1999, the Dow Jones average has increased 13-fold (from about 820 in November 1979 to about 10,600 in November 1999), average home prices in the U.S. have more than doubled (from about $64,000 in 1979 to about $162,000 in 1999, per the National Association of Realtors) and average consumer prices have more than doubled (what cost $500 in November 1979 cost $1,108 in November 1999, per the CPI Detailed Report by the U.S. Department of Labor, Bureau of Labor Statistics, November 1999). The $500 threshold should be increased significantly to reflect these and similar economic changes that have occurred since 1979.

Also, when the $500 threshold was adopted in 1979, the rule was intended to cover both business opportunities and franchises. You propose to continue using the $500 threshold even after the rule is revised to cover only franchises. While the $500 threshold may be relevant to business opportunities, it is irrelevant to most franchises. Franchisees generally pay $5,000 to $30,000 initial franchise fees for franchises, and invest significant additional funds to establish their franchised businesses (see The Profile of Franchising, at Charts 4.2, 5.1 and 5.2, 1999). While the $500 threshold may still be appropriate to any rule adopted for business

opportunities, the threshold is outdated and irrelevant in the context of the franchise rule.

You have observed that many state franchise disclosure laws still use $500 thresholds for franchises. This is true. Some state laws even have $100 thresholds (California Administrative Code, §310.011; Minnesota Franchises Act, §80C.01, Subd. 4(c)(3)(f)). While we believe that federal and state franchise disclosure laws should be consistent to the extent possible, we urge you to take the lead in increasing the minimum required payment threshold for franchises to a more realistic level in the context of current typical franchise investment realities.

25. §436.10 – Additional Provisions

In §436.10(e), you indicate that a prospective franchisee will be able to agree to "contractual terms and conditions that differ from those specified in the disclosure document" if specified conditions are met.

We recommend that you word the specified conditions as follows:

> "if: (1) the franchise seller identifies the changed terms and conditions; (2) the prospective franchisee has 5 days before signing the contract or paying any fee to review the revised contract; and (3) the prospective franchisee initials the changed terms and conditions before or when signing the revised contract."

This recommended wording is similar to your proposed wording, but transposes items (2) and (3), and makes it clear that the prospective franchisee may initial the changed terms and conditions before or when signing the revised contract.

We make this recommendation because we believe that most prospective franchisees would be reluctant to initial changes before signing franchise agreements, and because it generally is more prudent and practical to initial changes when franchise agreements are signed, rather than beforehand.

We also recommend that some flexibility be included in the rule or its Interpretive Guides for a franchisor or subfranchisor to make additional changes to a franchise agreement during the final 5-day review period, if the changes are requested by and favorable to a prospective franchisee or directly relate to those requested changes, without having to re-start the 5-day review period. This will more closely reflect reality in the franchise industry, which often involves the prospective franchisee seeking changes to the franchise agreement right up until the time of signing the franchise agreement, if the franchisor or subfranchisor has shown a willingness to negotiate the agreement.

26. Section H – Question 40

You have asked whether a franchisor or subfranchisor should be required to state in its disclosure document the names, addresses and telephone numbers of the primary individuals who were responsible for preparing the disclosure document.

We oppose a requirement of this type.

A franchisor's or subfranchisor's decision whether to select legal counsel and other individuals responsible for assisting in the preparation of a disclosure document is a private business matter, not a public one. In addition, including this information in a disclosure document would probably cause prospective franchisees to contact the individuals, which would bring them into the franchise sales process and possibly cause them and the franchisor or subfranchisor unexpected liability and expense.

Individuals (such as attorneys and consultants) who assist franchisors and subfranchisors in preparing their disclosure documents differ from auditors. Auditors make representations in their audited financial statements that are then given to prospective franchisees. Attorneys and consultants who assist in the preparation of disclosure documents do not make representations to prospective franchisees. Instead, they merely assist franchisors and subfranchisors in the preparation of those companies' representations to prospective franchisees.

**Attachment A**

## INFORMATION ON
## WARREN L. LEWIS, ESQ., OF LEWIS & KOLTON, PLLC

WARREN L. LEWIS has practiced business law for more than 27 years. He is a founding member of the Washington, D.C. law firm of Lewis & Kolton, PLLC, which represents clients on domestic and international franchising, licensing, trademark, copyright, unfair competition and antitrust counseling, registration and litigation matters.

Warren has been an author of franchising articles in Franchising World, Entrepreneur and other business publications; has testified before the U.S. Congress on franchising subjects; and is a frequent speaker at U.S. and international franchise conferences. He published a first-of-its-kind study on the use of earnings claims by U.S. franchisors in 1988. That study was cited favorably by the U.S. Federal Trade Commission and the Committee on Small Business of the U.S. House of Representatives. At the IFA's 25th Annual Legal Symposium in May 1992, Warren released a second study on the use of earnings claims by U.S. franchisors.

Warren authored a 544-page book titled FRANCHISES: Dollars & Sense, which revealed the earnings achieved by franchisees in 70 types of businesses. The book was published by the Kendall/Hunt Publishing Company. He wrote a chapter, "Canadian Franchisors Heading for the United States," for a MacMillan Canada book titled The Complete Guide to Franchising in Canada (authored by Ted LeValliant).

Warren is a member of the Advisory Committee to the Franchise and Business Opportunity Project Group of the North American Securities Administrators Association (NASAA), IFA's Legal/Legislative Committee, the IFA's Council of Franchise Suppliers, the American Bar Association (including the Forum on Franchising), and the International Bar Association (including the Business Law International Franchising Committee). He is Legal Counsel to the Capital Area Franchise Association, a former member of the AAFD's Fair Franchising Standards Committee, and a recipient of the IFA's "Franny" Distinguished Achievement Award.

Warren is a graduate of the George Washington University (J.D., *honors*, 1972) and the University of Maryland (B.S., *high honors*, 1967), and was Notes Editor of the George Washington University Law Review.

**Attachment B**

**INFORMATION ON THE COMPANIES AND ORGANIZATIONS SUPPORTING THESE COMMENTS**

| **Company/Location** | **Approximate No. of Franchised Units** | **Description of Franchised Businesses** |
|---|---|---|
| **Aire Serv Heating & Air Conditioning, Inc.**<br>Waco, TX | 43 | Install, maintain and repair residential and commercial heating, ventilating and air-conditioning equipment |
| **Blimpie International, Inc.**<br>New York, NY | 2040 | Operate BLIMPIE and PASTA CENTRAL restaurants |
| **CleanNet USA, Inc.**<br>Columbia, MD | | Operate a commercial cleaning business |
| **Commission Express National, Inc.**<br>Fairfax, VA | 8 | Purchase accounts receivable in the form of pending real estate sales commissions<br>. |
| **CGI Franchise Systems, Inc.**<br>***dba* Worldwide Express**<br>Dallas, TX | 71 | Re-sell air express services primarily to small and medium-sized businesses |
| **Dairy Queen Territory Operators Organization**<br>Washington, DC (organization of subfranchisors) | 1,230 | Operate DAIRY QUEEN/BRAZIER restaurants |

| Company/Location | Approximate No. of Franchised Units | Description of Franchised Businesses |
|---|---|---|
| **Dreammaker Bath & Kitchen by Worldwide**<br>Waco, TX | 196 | Re-glaze and re-color bathtubs, sinks and tile, install acrylic tubliners and wall systems, set tiles, resurface countertops, etc. |
| **Glass Doctor**<br>Waco, TX | 23 | Repair and replace auto and flat glass, and provide other glass-related services and products |
| **Interstate Dairy Queen Corporation**<br>Chevy Chase, MD | 125 | Operate DAIRY QUEEN/BRAZIER restaurants |
| **Mr. Appliance Corp.**<br>Waco, TX | 20 | Provide services and repairs on appliances for residential and commercial customers |
| **Mr. Electric Corp.**<br>Waco, TX | 55 | Perform electrical services and repairs |
| **Mr. Rooter Corporation**<br>Waco, TX | 188 | Perform plumbing, sewer, drain, pipe cleaning, water heater replacement and related services |
| **NaturaLawn of America, Inc.**<br>Frederick, MD | 33 | Provide lawn care services that utilize organic-based biological treatments |

| Company/Location | Approximate No. of Franchised Units | Description of Franchised Businesses |
|---|---|---|
| **PostalAnnex+, Inc.**<br>San Diego, CA | 228 | Sell business support, mailbox, postal, photocopying, packaging, shipping, office supply and related services and products |
| **Rainbow International Carpet Dyeing & Cleaning Co.**<br>Waco, TX | 379 | Provide carpet cleaning, dyeing, repair, reinstallation and related services |
| **Stuckey's Corporation**<br>Chevy Chase, MD | 49 | Sell candies, confections, nut items and gift items |
| **Sureway Air Traffic Corporation**<br>***dba* Sureway Worldwide**<br>Long Island City, NY | 5 | Provide worldwide air express and freight forwarding services |
| **Swisher Hygiene Franchise Corp.**<br>Charlotte, NC | 114 | Provide hygiene products and services to restaurants, retail stores and other commercial establishments |
| **The Dwyer Group, Inc.**<br>Waco, TX | N/A | (Holding company for multiple service-based franchise companies) |
| **Val-Pak Direct Marketing Systems, Inc.**<br>Largo, FL | 205 | Print, publish and distribute cooperative direct mail advertising |

| Company/Location | Approximate No. of Franchised Units | Description of Franchised Businesses |
|---|---|---|
| **WOW Development Corporation** *dba* **Wonders of Wisdom Children's Centers**<br><br>Prince William, VA | 3 | Provide child care for children, including pre-school, kindergarten and early elementary educational programs |

## Attachment C

## REGISTRATION EXPIRATIONS IN FYE STATES

| STATE | EXPIRATION DATE | CITATION |
|---|---|---|
| California | 110 days following FYE | § 310.120 |
| Hawaii | 60 days following FYE | § 482E-3(d) |
| Minnesota | 120 days following FYE | § 80C.08 |
| New York | 120 days following FYE | § 200.8 |
| Rhode Island | 120 days following FYE | § 19-28.1-9(d) |
| South Dakota | 120 days following FYE | § 37-5A-41 |