BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

November 12, 2004

Federal Trade Commission
Office of the Secretary
Room H-159 (Annex W)
600 Pennsylvania Ave., N.W.
Washington, D.C. 20580

Re: "Franchise Rule Staff Report R511003"

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

Dear Commission:

The Franchise Law Committee (the "Committee"), a standing committee of the State Bar of California's Business Law Section (the "Business Law Section"), consists of California attorneys who practice extensively in the franchise law area and includes among its members franchisor in-house counsel, as well as private practitioners who represent franchisees and/or franchisors.

The Committee's mission includes commenting on and proposing legislative and regulatory changes affecting franchising. This letter presents comments in response to the Commission's Request for Comments announced on August 25, 2004, related to the Proposed Revised Trade Regulation on Disclosure Requirements and Prohibitions Concerning Franchising.

These comments are provided by the Franchise Law Committee of the Business Law Section of the State Bar of California. Please note that the views and positions set forth in this letter are only those of the Committee. As such, they have not been adopted by the State Bar's Board of Governors, its overall membership or the overall membership of the Business Law Section, and are not to be construed as representing the position of the State Bar of California. **Membership in the Business Law Section, and on the Committee, is voluntary and funding for activities of them, including all legislative activities, is obtained entirely from voluntary sources.**

The Committee would like to commend the Commission on its efforts to modernize and improve its Franchise Disclosure rules. In general, the Proposed Rule provides a fair and balanced approach to the concerns of franchisors and franchisees in this area.

However, the Committee believes the Proposed Rules would be greatly improved by adopting the attached proposed changes. The attached comments represent the viewpoint of the Committee.

We appreciate this opportunity to provide our comments. If you have any questions or need any further information, do not hesitate to contact any of the individuals listed below.

Sincerely yours,

Stafford Matthews
Co-Chair, Franchise Law Committee

xc:

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COMMENTS ON THE PROPOSED DEFINITIONS

Addition of “Subfranchisor” Definition, Section 436.1

The Proposed Rule imposes significant obligations on a "subfranchisor", but fails to define the term "subfranchisor." It would be a substantial benefit for practitioners to have the term “subfranchisor” defined in the regulations rather than being defined solely in the commentary. Moreover, its inclusion in the regulations would clarify the term’s meaning and give it more authority than if it were not defined in the regulations.

In its comments to section 436.6(e), the Staff notes that the term subfranchisor “is often confused with ‘broker’ or other franchisor agents.” The lack of a uniform definition among the state disclosure statutes contributes to this confusion. For example, the Illinois definition [Section 705/3(4) and (5)] is substantially broader than the California definition (Corp. Code Sections 31008.5 and 31009), which has been copied by several other states.

As noted in a leading treatise in the field:

> “In a pure subfranchising relationship, the subfranchise agreement is between the master franchisee and the unit subfranchisee, the latter having no contractual privity with the franchisor.” Franchising Law Practice and Forms, The Franchisor § 4.07 [4]

While subfranchise relationships may (or may not) also involve payments by the Subfranchisor to the Franchisor of a portion of the funds received by the Subfranchisor from its (operating unit) Franchisees, and/or the providing of services by the Subfranchisor to its (operating unit) Franchisees, the core elements in a subfranchise relationship are that the Franchisor has sublicensed the Subfranchisor to offer franchises using the Franchisor’s trademarks or other intellectual property **and** there is direct contractual privity between the Subfranchisor and its (operating unit) Franchisees.

To avoid further confusion the Franchise Law Committee recommends that the definition of “Subfranchisor” and “Subfranchise” be added to the Proposed Rule at Section 436.1(v) and (w) as follows:

> “(v) Subfranchisor means a person who has been awarded a subfranchise.”
>
> “(w) Subfranchise means a relationship in which (a) the Subfranchisor has received from another person or entity the right to offer and sell franchises, using one or more trademarks or other intellectual property derived from such other person, and (b) the franchise agreement granted by the Subfranchisor will be directly between the Subfranchisor and the person to whom it grants a franchise.”

The remaining two definitions should be re-lettered to reflect the addition of these definitions.

By adding the definition for subfranchisor to the Proposed Rule, it does not appear necessary to include the second sentence of the definition of Franchisor in Section 436.1(k) that states: “Unless otherwise stated, it includes subfranchisors.”

In the alternative, if the FTC does not wish to adopt a definition of "Subfranchisor" as recommended above, the Franchise Law Committee recommends that the definition of "Subfranchisor" set forth in the FTC Staff's comments to the Proposed Rule be added at Section 436.1(v) as follows:

"(v) Subfranchisor means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance.”

Similarly as above, by adding the definition for subfranchisor to the Proposed Rule, it does not appear necessary to include the second sentence of the definition of Franchisor in Section 436.1(k) that states: “Unless otherwise stated, it includes subfranchisors.”

In reviewing the Staff comments to section 436.6(e) on page 215 of the Staff Report, the staff indicates that “subfranchisors are treated the same as franchisors under the Rule in narrow circumstances only: where the subfranchisor steps into the shoes of the franchisor by both granting franchises, as well as by performing post-sale disclosure obligations.” The last section of that sentence should read “post-sale **performance** obligations.”

COMMENTS ON THE PROPOSED DISCLOSURE DOCUMENT

Section 436.5(e), Item 5

The change from "initial franchise fee" to "initial fee" in this item appears to have (unintentionally) raised a potential issue, concerning the sale price of company-owned units. If a franchisor (or an affiliate of the franchisor) sells company-owned units (either routinely or sporadically), the purchase price for those units may fall within the definition of "initial fees" as a "payment[] ... for services or goods received from the franchisor or any affiliate before the franchisee's business opens...." Assuming that the sale price for those units is not uniform, that raises two concerns. First, there may not be a standard formula used to determine prices, and (if there is) the franchisor may be reluctant to reveal that formula. Additionally, if the number of such sales made in the prior year is limited, revealing the range in the prior year may have the consequence of making public the price paid by a particular franchisee.

None of the comments previously submitted by other parties to the FTC appear to have advocated this result, focusing (instead) on other fees payable to the franchisor or its affiliates. To remedy this issue, the Franchise Law Committee recommends that the language be amended to read as follows:

> 436.5(e)
>
> Item 5: Initial Fees Paid to Franchisor
>
> Disclose the initial fees and any conditions under which the fees are refundable. If the initial franchise fees are not uniform, disclose the range or formula used to calculate the initial franchise fees paid in the fiscal year before the issuance date and the factors that determined that amount. For this section, "initial franchise fees" means all fees and payments, or commitments to pay, for the right to obtain a franchise, while "initial fees" means all fees and payments (including all initial franchise fees), or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens, whether payable in lump sums or installments. Disclose installment payment terms in this subsection or in paragraph 436.5(j) of this section.

Section 436.5(f), Item 6

The Franchise Law Committee understands that it is the intention of the Staff that the proposed requirement that franchisors "list all required payments made directly to third parties and then state either the amount of the fee or that 'the amount of the fee is unknown and may vary ...'" is intended to be limited to payments *required by the franchisor* (as opposed to payments required by practical necessity). As a result, for example, wages/salaries of employees need not be disclosed (even if employees are effectively required) unless the franchisor requires a particular number of employees or a particular compensation rate. To clarify that intent, the Franchise Law Committee recommends that the introductory paragraph of this section be amended to read as follows:

> 436.5(f)
>
> Item 6: Other Fees
>
> Disclose, in the tabular form shown below, all other fees that the franchisee must pay to the franchisor or its affiliates, that the franchisor or its affiliates impose or collect in whole or in part for a third party, or that the ~~franchisee is required~~ franchisor requires the franchisee to pay directly to a third party. Include any formula used to compute the fees.

Section 436.5, Item 23

The second paragraph under the “Receipt” heading should be altered to conform to the language in the commentary section as follows:

If [name of franchisor] offers you a franchise, it must provide this disclosure document to you 14 days before you sign a binding agreement with or make a payment ~~with~~ to the franchisor or an affiliate in connection with the proposed franchise sale.

COMMENTS ON THE PROPOSED EXEMPTIONS

Section 436.8(a)(5)(i)

The intent of this section is to exempt sophisticated franchisees from disclosure based on the size of the investment in the franchise. In the proposed exemption, the measurement of the investment size refers to the "estimated investment" and the amount of the "franchise sale." From the commentary, it appears that the idea is to estimate how much money it would cost to get into and open the business and if that amount exceeds $1 million, the transaction should be exempt from disclosure requirements. However, neither of the two phrases in the exemption ("estimated investment" or "franchise sale") clearly set boundaries on the timeframe during which the investment amount is measured or exactly what is included in that amount. As it is currently phrased, the investment amount could be interpreted to include ongoing "investments" in the business, such as equipment and building maintenance, insurance, salaries, and the like. Over the life of the franchise, these expenditures would likely add a significant amount to the overall investment in the business such that many franchise sales would unintentionally fall under this exemption. In addition, these types of expenditures are highly speculative and could vary greatly from sale to sale depending on the particular circumstances of the deal. Moreover, including such expenditures would likely render the $1 million threshold meaningless in many circumstances because the accumulated expenditures over a 10 or 20 year period could easily exceed $1 million dollars. Further, ongoing expenditures do not reflect the cost of the investment as many of these expenditures are paid for out of existing cash flow at the time of the expenditure.

The Franchise Law Committee recommends that the exemption be amended to clarify that this exemption applies to the "initial investment" in the franchise. The concept of the initial investment in a franchise is discussed at length in the Item 7 disclosure requirement and we believe that concept should be used here. Specifically, as required in the Item 7 disclosure, the initial investment should include some expenditures during the initial period of operation. During the initial period of operation, atypical expenditures may be made, including advertising for a grand opening event and other similar expenditures that are not recurring throughout the term of the franchise. Those expenditures are more properly categorized as "initial investments" rather than ongoing costs and should be included in determining the size of the franchisee's initial investment in the franchise. Therefore, it is important to look at expenditures that are made both before and shortly after opening the franchise. The Franchise Law Committee recommends that the term "initial" be inserted before "investment" and the phrase "before operations begin and during the initial period of operations" be inserted after "investment." Further, the required notice should be reworded to track the language of the exemption. Following is the Franchise Law Committee's proposed revision to Section 436.8(a)(5)(i):

436.8(a)(5)(i)

(i) The franchisee's estimated initial investment before operations begin and during the initial period of operations, excluding any financing received from the franchisor or an affiliate and excluding real estate costs, totals at least $1 million and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption. The acknowledgment shall state: "The franchisee's estimated initial investment before operations begin and during the initial period of operations, excluding any financing received from the franchisor or an affiliate and excluding real estate costs, totals at least $1 million~~franchise sale is for more than $1 million, excluding real estate costs~~, and thus is exempted from the Commission's Franchise Rule disclosure requirements, pursuant to 16 C.F.R. § 436.8(a)(5)(i)";

Section 436.8(a)(6)

The proposed exemption under 436.8(a)(6) refers to a "purchaser" without specifically indicating whether a purchaser is limited to an individual or includes other business entities. It is common for an individual who would meet the requirements for this exemption to set up a partnership, corporation, limited liability company or some other business arrangement when purchasing a franchise. A person who is an officer or director of a corporation, general partner of a partnership, or manager or managing member of a limited liability company, should be able to qualify for the exemption. The form of entity that they use to purchase a franchise does not alter the basis on which the exemption is based. The Franchise Law Committee therefore recommends that the exemption be altered to clarify the intention to include situations where the purchaser is not an individual.

The proposed exemption refers to the term "ownership interest" as one of the criteria. The phrase is ambiguous in that it could include non-equity ownership interests such as debt. A lender typically does not participate in the business at the same level as an equity owner. Therefore, the Franchise Law Committee recommends that the term "equity" be substituted for "ownership" to clarify that the exemption only applies to purchasers who have an equity interest.

With regard to the qualifications for the exemption, the Franchise Law Committee recommends that the term "manager or managing member" be added to the list of qualified positions so that a franchisor organized as a limited liability company would be able to use this exemption. Further, we note that only two categories of individuals who do not qualify as an "officer, director, general partner, or manager or managing member" are eligible for this exemption – a person with management responsibility for sales of franchises and the administrator of the franchised network. The Franchise Law Committee believes that these two categories should be expanded. For example, a director of operations or marketing would arguably have as much or more knowledge of the business and its operation than someone responsible for either the sale or administration of the franchise. These types of individuals generally have management

responsibility for the company as a whole and would have substantial knowledge of the business and its operation as well as any differentiation in experiences across the system. However, managers of individual stores or small portions of a system's total operation should not qualify for the exemption as their experience would typically be more limited. Therefore, the Franchise Law Committee proposes to include individuals with management responsibility for a significant portion of a franchisor's business within this exemption. Because this phrasing would include the administrator of the franchisor's system, that phrase should be deleted as redundant.

Finally, in order to exclude a "sham owner" of the franchisor, the ownership interest should refer to "voting power." Moreover, indirect ownership of the interest should be allowed so that an ownership interest held by a trust for an individual is included.

Following is the Franchise Law Committee's proposed revision of Section 436.8(a)(6).

436.8(a)(6)

(i) One or more ~~purchasers~~ persons purchases ~~of~~ at least a 50 percent ~~ownership~~ equity interest in the franchise and that purchaser, or an officer, director, general partner, or manager or managing member of that purchaser, as of a date ~~: (1)~~ within 60 days of the sale, has been, for at least two years, either:

(a)~~,~~ an officer, director, general partner, manager or managing member, or an individual with management responsibility for (1) the offer and sale of the franchisor's franchise~~es~~, or (2) a significant portion of franchisor's business ~~or the administrator of the franchised network~~; or

(~~2~~b) ~~within 60 days of the sale, has been, for at least two years,~~ an owner, directly or indirectly, of at least ~~a~~ 25 percent of the voting power of ~~interest in~~ the franchisor.

Section 436.9(f)

The proposal by the Staff to require existing disclosures to be provided to prospective purchasers of an existing outlet is commendable, provided that the Rule is amended to clarify that a franchisor is relieved from that duty if the existing disclosure would be misleading (for instance, if through the passage of time or a change in material facts, delivery of the most-recently prepared disclosure statement would be misleading). The following insertion at the end of Section 436.9(f) is suggested:

> For purposes of this subsection, an "existing disclosure" is a previously-prepared disclosure document (and quarterly updates, if any) that was prepared in the ordinary course by the franchisor and that is not misleading due to a subsequent change in material facts. This subsection does not obligate a franchisor to prepare (or to update) a disclosure if the franchisor would not otherwise have done so for purposes of its own sales.

Section 436.9(i)

Concerning the issue of integration clauses, the Staff requested comments on whether the proposed prohibition on reliance on the language in the disclosure document strikes the correct balance as applied to contract terms. Franchise agreements are long-term contracts, that (of necessity) must deal with unforeseen circumstances (as an easy example, who thought of the Internet 20 years ago?). Any particular language (legalese or not) will have some level of problems when trying to apply it to that sort of unforeseen issue; if there are two different descriptions (especially one "legalese" and one "plain English"), the chances of misunderstanding multiply. It is the opinion of the Franchise Law Committee that outlawing integration clauses (even in the limited area proposed by the Staff) is likely to cause the importation of more "legalese" into disclosure documents (even if only in the limited areas noted by the Staff) to minimize the possibility of conflicts. Even the most-careful drafter cannot avoid all conflict when compared with unforeseen developments. If the franchisor is able to include (and rely upon) an integration clause, it decreases that potential for problems arising from unintentional inconsistency. It is the Committee's belief that the Commission's other enforcement powers are sufficient to address the problems of franchisors that intentionally misrepresent the provisions of their contracts, without undertaking such a radical modification of contract law.

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