WITMER, KARP & WARNER LLP
COUNSELLORS AT LAW
22 Batterymarch Street
Boston, Massachusetts 02109
Telephone (617) 423-7250
Fax (617) 423-7251

Eric H. Karp
ekarp@wkwllp.com

November 12, 2004

Donald S. Clark, Secretary
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Washington, DC 20580

Re: Franchise Rule Staff Report, R511003
Comments to Staff Report to the Federal Trade Commission and
Proposed Revised Trade Regulation Rule

Dear Secretary Clark:

Thank you for this opportunity to provide comments to the Staff Report to the Federal Trade Commission ("Staff Report") and Proposed Revised Trade Regulation Rule ("Proposed Rule").

I am a franchise attorney who represents franchisees and franchisee associations. The franchise systems in which we are counsel to an association of franchisees are McDonalds, Domino's Pizza, Denny's, Jackson Hewitt, Pearle Vision, Portable on Demand Storage, 7-Eleven and Colors on Parade.

The Staff is to be commended for an exceptionally well organized and thorough report. However, we are of the view that the Proposed Rule makes many unnecessary and ill-advised changes to the form of the Franchise Rule reflected in the Notice of Proposed Rulemaking (NPR); many of these are concessions in favor of franchisor interests that are not supported by the record and are inconsistent with the rationale for the Rule. In many cases, the Staff has overstated or speculated about the burdens of additional or enhanced disclosures sought by franchisee advocates. As a result, many franchisors have good reason to be pleased with the Proposed Rule. See Kaufman, *Franchisors' Perspective: Many Attractive Proposals*, Leader's Franchising Business & Law Alert, October/November 2004.

I submit the following comments to the Proposed Rule in no particular order of priority.

1. Unfairness Jurisdiction

The Proposed Rule would perpetuate the FTC's stance that its unfairness jurisdiction should not be extended to address the substance of the franchisee-franchisor relationship. The Staff Report's view that the FTC's authority does not extend to the relationship issues that predominate in franchise disputes and litigation is based on the erroneous notion that the typical and remarkably uniform franchise agreements in use today are not unfair as a matter of law; this is simply wrong, would be contradicted by a reading of a typical franchise agreement and confirmed by studying the extent to which agreements in franchise systems have been changed over the years to make them progressively less favorable to the franchisee. The consistent refusal of the FTC to enter this arena is an abdication of responsibility that has created a power vacuum during the nearly 27 years that the Rule has been in effect, allowing the development of franchise agreements reflecting a steadily and increasingly stark imbalance of legal and economic power. The Staff Report ignores the reality of the franchise marketplace and its grossly one-sided take-it-or leave-it franchise agreements that in any other sector of our economy would be seen as grossly unfair and even predatory.

Contrary to the prediction of the FTC when the Franchise Rule was first enacted, our Courts have consistently held that no private right of action exists for violations of the Rule. While that void can now only be filled by Congress, the Commission should use the power granted to it under 15 U.S.C. §45(n) to address the grossly unfair franchise agreements that are currently the norm. Market forces and pre-sale disclosure have not stemmed this tide and are unlikely to do so in the future.

2. Item 3 - Franchisor Initiated Lawsuits

We strongly support the required disclosure of franchisor-initiated lawsuits concerning the franchise relationship. The extent to which a franchisor has filed lawsuits to collect unpaid royalties from franchisees, or enforce a non-competition covenant, or has filed a pre-emptive complaint for declaratory judgment is important information for a prospective franchisee. The race to the courthouse between franchisor and franchisee should not be the determining factor as to whether the litigation should be disclosed or how material it may be.

However, we do not agree with the Staff Report recommendation that only those franchisor-initiated lawsuits filed within the previous 12 months need be disclosed. There is no rational reason why a lawsuit commenced by a franchisor more than 12 months prior has any less relevance than a franchisee-commenced lawsuit commenced five years prior to the date of the disclosure document. There is no support for the notion that disclosure of such lawsuits for the previous three years would be excessive or overly burdensome; nor does the record support the notion that the number of lawsuits filed by a franchisor in a particular fiscal year is representative of either the types of problems that generally arise in the system or the propensity of the franchisor to sue its franchisees.

We reject the notion that it would somehow be an unfair burden for a franchisor to be required to disclose all lawsuits and all settlements that have any bearing on the franchise relationship. The reality is that these lawsuits are very expensive. The additional cost associated with writing a single paragraph to describe the lawsuit pales by comparison with the resources devoted to the litigation itself.

3. Item 19- Financial Performance Information

The absence of financial performance information in the typical UFOC creates a vacuum that allows and even encourages extra-legal representations as to income and profits. No disclaimer within the UFOC will prevent this inevitable disclosure as it is human nature to desire an answer to the central question about any potential business, whether franchised or not: "What will it take in and what will I earn?"

The fiction that franchisees can and should buy a franchise without receiving this most elementary data is well outside the norm in commercial practices. Virtually every publication one might consult on how to appraise a business starts with the production of multiple years of financial statements. Indeed, most franchisors now require franchisees to provide detailed financial performance data on their business, but then withhold that same information from prospective franchisees.

The Commission has a valuable opportunity here to bring franchise sales into compliance with the normal and customary standards that govern the sales of businesses and end the withholding of this vital data that franchisors collect and use for their internal purposes. It is time to end the prevailing practice of earnings claims being made with deniability.

Finally, the proposed second preamble should be strengthened to state that if the franchisor does not provide financial performance information, the prospective franchisee should be concerned about and wary of the motives behind the withholding of such vital information. We suggest that the following be added as the second sentence of the second preamble found at §436.5(s)(2):

> *The franchise agreement requires you to give us a wide array of financial performance information on your business should you become a franchisee. This will include quarterly income statement and balance sheets as well as year-end financial statements and tax returns. You should consider why we are unwilling to provide you with that kind of information from our current franchisees before you sign the franchise agreement.*

4. Item 20 Issues

A. Transfers

The Proposed Rule should require disclosure of the extent to which franchisees in the system have been granted or denied requests for approval for transfer. This would help the prospective franchisee determine the likelihood of being able to harvest his or her equity in the franchised business in the future.

B. Turnover Rates

The Proposed Rule does not provide the prospective franchisee with an effective means to determine the frequency with which units in the system change hands. We again urge the Commission to seize the opportunity to create an industry-wide definition of turnover rates, ending the controversy over this vital statistic and creating the ability to compare systems in a meaningful fashion.

C. New Outlet Projections

We continue to see instances where franchisors often make wildly unrealistic projections of new outlets, seeking the prospective franchisee's reliance on the promised rate of growth. This is the only area of franchise disclosure where the franchisor is permitted to make a prediction of future events, and thus requires special scrutiny. We urge the Commission to enforce some discipline in this area by allowing prospective franchisees to track what the franchisor has previously predicted against what actually transpired. The Proposed Rule requires a reasonable basis for Item 19 disclosures, but it does not apply any similar standard for new outlet projections.

D. Franchisee Associations

The Staff Report recommends the retention of an important advancement for the benefit of prospective franchisees: the mandated disclosure of trademark–specific franchisee associations. This is a laudable recognition of the legitimate and constructive role that franchisee associations can and do play in our industry, including acting as an unfiltered source of information for prospective franchisees. Providing this source of information is essential, given the absence of mandated financial performance information in Item 19, the prevalence of the use of broad confidentiality agreements in franchise agreements and settlement agreements, and the fact that the franchisee roster in Item 20 need not contain more that 100 names. The proposal builds on the body of statutory and regulatory law in 11 states that explicitly protects the rights of franchisees to freely associate and a line of judicial decisions that demonstrate the willingness of judges and juries to finds creative ways to punish franchisors that retaliate against franchisee association members and leaders.

The Staff Report contains three recommended changes to Section 436.5(t)(8), two of which we support and the third we oppose.

First, the requirement that the disclosure document include not only the name, address and telephone number of the association but also its e-mail and web addresses will further the stated purpose of facilitating contact with association leaders. We urge the Commission to accept this recommendation.

Second, the clarification to the Proposed Rule stating that the association must renew its request for inclusion in the disclosure document within 90 days after the close of the franchisor's fiscal year is reasonable and will avoid confusion.

Third, the provisions of the Proposed Rule granting the franchisor the option to add a disclaimer regarding its lack of endorsement of the association and a statement that the association may not represent the interests of all franchisees in the system, are steps backward that undercut the stated rationale for the disclosure. If a franchisor chooses to include a specific, indeed pointed statement that it does not endorse the association, this is likely to create a substantial disincentive for a franchisee to make contact with the association. It implies an adversarial relationship between the franchisor and the association, which in most systems is simply not a reflection of reality. Several commenters to the NPR suggested that franchisee associations can be the source of mis-information with a narrow and anti-franchisor agenda. These generalizations find no support in the record and are contrary to the experiences of this writer. Yet, a prospective franchisee surely will not wish to be found to have contacted an association of which the franchisor does not approve.

Further, a statement in the disclosure document that an association may not represent <u>all</u> franchisees would be gratuitous, and although it would almost always be literally true, would not convey meaningful information. No voluntary organization can hope to achieve 100% membership of the franchisees in a system. The IFA claims to be "The Voice of Franchising", yet it surely does not represent <u>all</u> franchisors. To suggest that a franchisee association is less than a legitimate source of information if it fails to meet that impossible standard makes it less likely the prospective franchisee will avail itself of what the NPR correctly characterized as an important source of material information from which he or she can learn about the system.

The proposed disclaimers are an overreaction to comments from a few franchisor representatives whose clients or constituents are apparently hostile to franchisee associations. These disclaimers would undermine the effectiveness of the proposed disclosure and should be rejected by the Commission.

5. Elimination of First Personal Meeting Disclosure Trigger

The Proposed Rule would gratuitously eliminate an essential bright line rule of disclosure that currently exists under the FTC Rule. This will increase the opportunities for fraud in the sales process.

It is certainly true that in the information age, much of what was once done in person is now done by e-mail, through overnight carriers, websites and by telephone. It is also true that many franchise sales are initiated without personal contact between the franchisor and the prospective franchisee. At the same time, there is no basis to believe that personal meetings will completely become a thing of the past.

The elimination of the trigger will allow the franchisor to conduct discussions with the prospective franchisee about the purchase of a franchise over an extended and theoretically unlimited period of time. These discussions will include information about the franchise which is required to be included in the disclosure document. During this period, the franchisee is likely to become emotionally invested in the transaction and the 14 day cooling off period will then commence when the franchisee has already decided to make the investment. The disclosure document will become a mere afterthought. This undermines the central purpose of the Rule which is to give the prospective franchisee the information necessary to make an informed choice before deciding to invest.

The first personal meeting disclosure trigger presents no real or extra burden to the franchisor. The disclosure document should be ready and available at the time of the first personal meeting, if there is one. There is no rational reason to allow the franchisor to begin the sale process while withholding the disclosure document that is designed to provide all information necessary for the franchisee to conduct his or her due diligence.

The provision of §436.9(e) to the effect that the franchisor must provide the disclosure document if the prospective franchisee requests one is antithetical to the purposes of the Rule and presupposes that the franchisee will know to make the request. Disclosure should be automatic and self-executing; the franchisor should not be sitting on the document with the right to withhold it, hoping the prospective franchisee will not ask.

Finally, Maryland and Rhode Island have their own statutory first personal meeting trigger that will not be preempted by the Franchise Rule. See §436.10(c) and *Business Franchise Guide (CCH)* ¶3200.23 and ¶3390.08. To the extent that Staff Report recommendation is followed, yet another inconsistency between federal and state law will be created, with additional compliance burdens to franchisors.

We strongly urge the Commission to retain the first personal meeting trigger.

6. Large Investment Exemption

The Large Investment Exemption should be deleted from the final Rule as not reasonably tailored to its stated objectives and unnecessary in any event. The size of the investment to be made by the prospective franchisee does not measure financial sophistication or tolerance for risk.

We urge the Commission to scrap this proposal altogether and instead to adopt the Large Franchisee Exemption recently enacted by the state of California. See Cal. Code §31109, added by Stats.2004, c.458 (A.B.2921), § 3, eff. Sept. 10, 2004, operative Jan. 1, 2005. See *Business Franchise Guide (CCH)* ¶3050.286.[1]

This would have the effect of broadening and better defining the Proposed Rule's Large Franchisee Exemption.

The new California law properly focuses on the financial resources and business experience of the owners of the franchise. Each purchaser must be an entity with at least $5 Million in assets, or an individual with at least $1 Million of net worth with a spouse, exclusive of home, home furnishings, automobiles and retirement assets, and income of at least $300,000 for the past two years or at least $500,000 of income with that person's spouse. Each owner must also have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of, and protect their own investment in, the franchise and not invest more than 10% of his or her net worth or joint net worth with a spouse in the franchise, exclusive of home, home furnishings, automobiles and retirement assets. We recommend retaining the five year standard for the business experience prong. These criteria would more effectively measure the extent to which the investor can evaluate the franchise without a disclosure document.

7. Disclaimers

We endorse proposed §436.9(e) which makes it a violation of Section 5 of the FTC Act to disclaim or require a franchisee to waive reliance on any representation made in the disclosure. A number of court decisions in this area have permitted reliance on the terms of a disclosure document to gain an understanding of or to interpret the provisions of a franchise agreement.[2] Allowing a franchisor to use an integration clause to bar proof of the warranties and representations in the disclosure document defeats the purpose of the Rule.

We endorse the comments of our colleague, Peter Lagarias, on this subject in his article, *Integration Clauses and the Proposed FTC Rule Revision*, Leader's Franchising Business & Law Alert, October/November 2004.

Moreover, proposed §436.9(e) should go one step further in a direction wholly consistent with proposed §436.9(a), which makes it an unfair or deceptive act to make a representation that contradicts the text of the disclosure document. It makes little sense to make such conduct illegal under Section 5 without insuring that evidence of the transgression will not be blocked by an integration clause in the franchise agreement. The purpose of the Rule is to require the franchisor to make disclosures under the Rule and not undermine those representations with oral or written statements to the contrary. This issue is of particular concern should the proposed elimination of the first personal meeting trigger become part of the final Rule. In that case, there will often be an extended period of time between the first communications and meetings and the time of formal disclosure under the Rule. This interim period will provide ample opportunity for extra-disclosure document warranties and promises. Only by extending the prohibitions on the use of waivers and disclaimers to conduct that violates the existing prohibitions on contradictory statements, will prospective franchisees reap the full benefit of proposed §436.9(e).

8. Confidentiality Clauses

By lumping together confidentiality agreements typically contained in franchise agreements with the kind of confidentiality agreements often contained in a settlement agreement, the proposed §436(t)(7) makes the disclosure of little benefit to prospective franchisees. It places no limits on the barriers franchisors can create that will dissuade franchisees from speaking about their experiences in the franchise system, whether or not they have been involved in litigation. It incorrectly implies that the franchisee that signed the confidentiality provision had a choice whether to do so or not. It sanctions the practice of using confidentiality agreements to prevent the effective use of the franchisee rosters as part of the due diligence process.

We hope that the foregoing comments will be useful to the Commission as it approaches the end of the Rulemaking process. We trust that you will not hesitate to contact us if there are any questions concerning these comments or if we can provide you with any additional materials or information.

Very truly yours,

Eric H. Karp

Endnotes

---

[1] The relevant sections of the new California exemption are as follows:

Any offer or sale of a franchise that meets all of the following requirements shall be exempt from Chapter 2 (commencing with Section 31110):

(a) Each and every purchaser of the franchise is one of the following:

…..

(2) Any entity with total assets exceeding five million dollars ($5,000,000) according to its most recent financial statements and not specifically formed for the purpose of acquiring the franchise offered. For purposes of this section, "entity" shall mean an organization described in Section 501(c)(3) of the Internal Revenue Code, a corporation, Massachusetts or similar business trust, limited liability company, or partnership. The financial statements referred to in this paragraph shall meet both of the following requirements:

(A) Be as of date not more than 90 days prior to the earlier of either the date on which the first prospective purchaser signs any binding franchise or other agreement with the franchisor in connection with the award of the franchise, or the date on which the franchisor receives any consideration from the first prospective purchaser in connection with the award of the franchise.

(B) Be prepared in accordance with either of the following:

(i) Generally accepted accounting principles and, if the entity has consolidated subsidiaries, on a consolidated basis.

(ii) The rules and requirements of the Securities and Exchange Commission, whether or not required by law to be prepared in accordance with those rules and requirements.

(3) Any natural person whose net worth, or joint net worth with that person's spouse, exceeds one million dollars ($1,000,000) at the time of his or her purchase of the franchise, excluding the value of that person's personal residence, any and all retirement or pension plan accounts or benefits, home furnishings, and automobiles.

(4) Any natural person whose gross income exceeds three hundred thousand dollars ($300,000) per year in each of the two most recent years, or whose joint gross income with that person's spouse exceeds five hundred thousand dollars ($500,000) per year in each of those years, and who reasonably expects to reach the same income level in the current year.

(5) Any entity, in which all of the equity owners are persons or entities described in either paragraph (1), (2), (3), or (4).

(b) Each and every purchaser of the franchise has knowledge and experience in financial and business matters, either alone or with professional advisers of the purchaser who are unaffiliated with, and not directly or indirectly compensated by, the franchisor or an affiliate or selling agent of the franchisor, such that the franchisor reasonably believes, based on reasonable inquiry before the sale, that each and every purchaser has the capacity to evaluate the merits and risks of, and protect their own interests in, the franchise investment.

(c) Each and every purchaser of the franchise purchases the franchise for the purchaser's own account, or a trust account if the purchaser is a trustee, for the purpose of conducting the business as a franchise and not with a view to, or for a sale in connection with, any resale or distribution of the franchise or any interest in the franchise.

(d) The immediate cash payment required from a purchaser of the franchise who is a natural person, upon the purchase of the franchise, shall not exceed 10 percent of that person's net worth or joint net worth with that person's spouse, exclusive of that person's personal residence, any and all retirement or pension accounts or benefits, home furnishings and automobiles.

….

[2] See Brennan v. Carvel Corp., 929 F.2d 801 (1st Cir. 1991) (finding that it is proper to look at a franchisor's disclosure statement in determining the intent of the agreement); Chicago Premium Yogurt, Inc. v. Yogurt Ventures, U.S.A., Inc., No. 91 C 0209, 1992 WL 3705 at *2 (N.D. Il. Jan. 2, 1992) (UFOC properly considered in assessing whether failure to approve assignment of franchise was a breach of the Franchise Agreement); TCBY Systems, Inc. v. RSP Co., 33 F.3d 925, 929 (8th Cir. 1994) (finding that it is proper to look to a franchisor's brochure as evidence of the meaning of the site selection provision of the parties' Franchise Agreement); Peterson v. Mister Donut of Am., Inc., No. 87-3205 (AET), 1988 WL 71734 (D.N.J. July 6, 1988); and Thompson v. Atlantic Richfield Co., 663 F. Supp. 206, 209-10 (W.D. Wash. 1986).