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November 12, 2004

FILED ELECTRONICALLY

Federal Trade Commission/Office of the Secretary
Room H-159 (Annex W)
600 Pennsylvania Avenue, NW
Washington, DC 20580

Attn.: Steven Toporoff
Eileen Harrington
J. Howeard Beales, III

Re: Comments on Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule, Disclosure Requirements and Prohibitions Concerning Franchising, R511003

Dear Mr. Toporoff, Ms. Harrington, and Mr. Beales:

We write in response to the Staff Report to the Federal Trade Commission and the Proposed Revised Trade Regulation Rule dated August 2004 (the "Staff Report").[1] Our firm principally represents franchisors in structuring franchise programs, preparing and registering disclosure documents and related agreements, negotiating the acquisition, sale and transfer of franchises, and the litigation and resolution of franchise disputes. Please note that our comments reflect our views and experience, and do not necessarily represent the views of our clients.

We commend the Staff for the hard work that has gone into the Staff Report. It is comprehensive and well thought-out. In the interests of time and brevity we have focused our comments on a limited number of issues which we believe will be of general and significant concern to franchisors.

Our comments below follow the organization of the Staff Report.

[1] References to Staff Report page numbers refer to the version of the Staff Report posted to the FTC website in pdf format.

1. **Definition of "Disclose" [Section 436.1(d)]**

As proposed, "Disclose, state, describe, and list mean to present all material facts accurately, clearly, and concisely, and legibly in plain English." We are concerned that this Section could be interpreted to require a franchisor to disclose every material fact regarding the offered franchise, rather than disclosing all material facts pertaining specifically to the disclosures required pursuant to the Rule. To avoid the potential that Section 436.1(d) will be read more broadly than intended, we suggest that this definition be revised to read as follows: "Disclose, state, describe, and list mean to present all material facts called for by the applicable disclosure Item, accurately, clearly, and concisely, and legibly in plain English."[2]

2. **Definition of "Principal Business Address" [Section 436.1(t)]**

The definition of the term "Principal Business Address" refers exclusively to the street address of the franchisor. The term, however, is used in Item 1 (Section 436.5) with reference to the Principal Business Address of any predecessor. We recommend that the definition of "Principal Business Address" be modified to read as follows: "Principal Business Address" means the street address of the applicable person's home office in the United States. A principal business address cannot be a post office box or private mail drop."

3. **Obligation to Furnish Documents [Section 436.2(a)]**

The Staff indicates on page 78 of the Staff Report that the 14 calendar day period will commence on the day after delivery and that signing can take place 15 days later. This is inconsistent with the method of computing time set forth in Rule 6 of the Federal Rules of Civil Procedure. Rule 6 essentially provides that when counting days you do not count the first day of the designated period, but do count the last day. We recommend that the Commission follow the method of counting days set forth in the Federal Rules of Civil Procedure.

4. **Obligation to Furnish Documents [Section 436.2(b)]**

Subsection (b) requires franchisors to deliver a revised copy of the "basic" franchise agreement seven days before it is signed only if the franchisor has unilaterally and materially altered the terms of the agreement. We note that on page 82 of the Staff Report the Staff states that, "This would exclude situations where the only differences between the standard contract and the completed contract are "fill-in the blank" provisions, such as the date, name, and address of the franchisee."

[2] This modification is supported by Section 436.6(c) which expressly limits the scope of disclosures. It states: "Do not include any materials or information other than that required by this Rule or by State law not preempted by this Rule."

a. Typically, "fill-in the blank" provisions may also include things such as the specific radius or geographic area comprising a protected territory; or the actual number of stores to be opened pursuant to an area development agreement, and the corresponding initial area development fee calculated in accordance with a formula set forth in the disclosure document (*e.g.*, $10,000 for each store required to be opened); or the specific interest rate payable by the franchisee where the disclosure document indicates that the rate will be, for example, 2% above the then published "prime rate," all of which are presumably material. Therefore, we recommend that subsection (b) either be modified to further exclude insertion of particular terms in the standard contract which are consistent with the range, formula or method specified in the Franchise Disclosure Document, or clarify that these types of insertions would trigger the seven day holding period.

b. In our experience, franchisees that negotiate the basic franchise agreement are also likely to negotiate ancillary franchise documents. We recommend that the language of this section be revised to apply to all of the agreements attached to the Franchise Disclosure Document.

c. To address the foregoing comments, we suggest the following revised language:

> "[It is an unfair or deceptive practice] for any franchisor to alter unilaterally and materially the terms and conditions of the franchise agreement or any agreement attached to the Franchise Disclosure Document without furnishing the prospective franchisee with a copy of each revised agreement at least seven days before the prospective franchisee signed that revised agreements. For purpose of determining whether a unilateral alteration is material, an alteration is not material if it selects or inserts provisions in the applicable agreement that are determined or calculated consistent with the range, formula or methodology set forth in the Franchise Disclosure Document. Changes to a franchise agreement that result solely from negotiations initiated by the prospective franchisee do not trigger this seven-day period."

5. <u>Obligation to Furnish Documents [Section 436.2(d)]</u>

Section 436.2(d) provides that franchise sellers will be liable for certain violations of the franchisor if the franchise seller "either directly participated in them or had the authority to control them." We find this language problematic for several reasons. First, it appears to create strict liability for all "franchise sellers," even where their "control" is limited, attenuated or indirect. Which "franchise sellers" have sufficient "control" over a Franchise Disclosure Document to warrant liability? Second, liability could be found for employees, advisors, consultants, attorneys, and accountants of a franchisor that "participate" in the preparation of the Franchise Disclosure Document or in the sales process in some manner. For example, by

performing a ministerial act, such as mailing a Franchise Disclosure Document to a prospective franchisee, would an employee, outside attorney, or other advisor be brought within the ambit of this Section? Outside consultants, advisors, attorneys and accountants that assist franchisors to prepare Franchise Disclosure Documents could seemingly be held liable for a franchisor's violation, even if the outsider had no knowledge of the facts underlying the violation. Is it intended that an attorney who represents a franchisor in negotiating and revising the franchise agreement be strictly liable for any franchisor violation?

6. Cover Page [Section 436.3(h)]

The required statement under subsection (h)(2) indicates that the disclosure document must be received 14 days before the prospective franchisee signs a binding agreement or makes a payment in connection with the franchise sale. The statement required under subsection (h)(2) is inconsistent with Section 436.2(a). Therefore, we recommend that the third sentence of subsection (h)(2) be amended to read as follows: "You must receive this disclosure document at least 14 days before you sign a binding agreement with or make any payment to the franchisor or any of its affiliates in connection with the franchise sale."

7. Item 1: The Franchisor, and any Parent, Predecessors and Affiliates [Section 436.5(a)]

Subsection (6)(vi) requires the franchisor to disclose a general description of the competition, including competition from any entity in which an officer of the franchisor owns an interest. It is not uncommon for one to purchase a small number of shares of a publicly held corporation in order to obtain its annual reports and other filings. Presumably, subsection 6(vi) would require the disclosure of such an immaterial ownership interest in a competitor. We recommend that subsection (6)(vi) be revised to read as follows: "A general description of the competition, including competition from any entity in which an officer of the franchisor owns a material interest. As used in this subsection a "material interest" means an interest of 5% or more of the equity securities of the applicable entity."

8. Item 4: Bankruptcy [Section 436.5(d)]

Subsection (1) reads as follows: "Disclose whether the franchisor, any parent, predecessor, affiliate, officer, general partner, or any other individual who occupies a similar status or performs similar functions has, during the 10-year period immediately before the date of this disclosure document:" This section is ambiguous as to whom the disclosures need to be made. Are they required of officers or affiliates of a predecessor, or officers of a parent or affiliate? We suggest that this section be modified to read as follows:

> "Disclose whether the franchisor, or any parent, predecessor, affiliate, officer, or general partner of the franchisor, or any other individual who occupies a similar status or performs similar functions for the franchisor has, during the 10-year period immediately before the date of this disclosure document:"

9. Item 6: Other Fees [Section 436.5(f)]

We believe that the language requiring the franchisor to disclose fees that the "franchisee is required to pay directly to a third party" is too broad. In addition to a potentially extremely wide range of predictable garden variety fees and payments such as lease payments for premises and equipment, ongoing purchases of inventory, office supplies and other goods and services, there are an almost infinite plethora of potential and unpredictable (or unknowable as a practical matter) payments and fees that may vary by locality, such as license and permit fees, or may arise due to unpredictable events during the operation of the franchise over a very long life (sometimes, 20 or more years into the future).

Many required fees (presumably including the term "payments" as is the case under Item 5) are necessary of all business owners, franchised or not, and their disclosure does not appear to further the purpose of educating the prospective franchisee about the particular franchise they are purchasing (as opposed to operating a business generally). In contrast, Item 1 limits disclosures of laws and regulations specific to the franchisor's industry rather than requiring disclosure of all laws applicable to running a business in general. Under the proposed expansion, must the franchisor list possible payments to attorneys and experts were a franchisee to be sued by a customer for spilling hot coffee, becoming obese, slipping on the premises, or by an employee for workers compensation, overtime violations or other employment practices? Further, as acknowledged by the Staff, the cost of the "fees" may not be within the knowledge of the franchisor or may vary substantially and the franchisor is proposed to be allowed to state that the fee is unknown and can vary. This could lead to an unwieldy disclosure covering so many potential types of third party payments (yet only stating that the fee is unknown and may vary), that the disclosure would lack practical utility.

10. Item 12: Territory [Section 436.5(l)]

In our experience, few franchisors grant a franchisee an "exclusive" territory, without any reservations of rights. Accordingly, the mandatory disclosures in clause (5) fail to provide real disclosure of the most typical of circumstances, and if retained, will require franchisors that in fact offer meaningful territorial protection (*e.g.*, that the franchisor will not operate or license a third person to operate a traditional franchised unit in the protected radius, but may operate or grant a license to operate an "express" franchised unit at an airport within the protected radius) to state that they do not grant an exclusive territory. We recommend that the Rule limit the proposed disclaimer to cases where no exclusivity at all is provided, and in other cases simply

require the franchisor to disclose what territorial rights are granted to the franchisee, and what rights are reserved to the franchisor.

11. Item 19: Financial Performance Representations [Sections 436.5(s) and 436.7(d)]

Clause (3) requires the franchisor to have a reasonable basis and written substantiation for the representations at the time the representations are made, and must state the representations in the Item 19 disclosure. Section 436.7(d) requires the franchisor to "notify" each purchaser, each time a disclosure document is delivered, whether any change has occurred that the seller knows or "should have known" in the information contained in any financial performance representation.

Given the fact that Item 19 disclosures are often multifaceted, sometimes covering not only gross sales but costs and expenses, different market segments, and different subtypes of franchised units, this requirement, though well intended, imposes an enormous burden on franchisors by requiring them to constantly update and re-run the numbers, and re-analyze them, potentially on a daily basis, to confirm that an adverse change has not occurred somewhere in the data. Franchisees typically report earnings on a monthly or even a weekly basis. New technologies permit daily polling of sales data by the franchisors. The mere receipt of the this data on an ongoing basis means the franchisor would, or at least "should," in fact "know" of a change even before actually realizing its implications in terms of Item 19.

Although the Commission and the Staff may interpret this section more restrictively liberally with respect to enforcement, it may not be interpreted in the same manner by a court or arbitrator in private actions brought by disgruntled franchisees, once this format is adopted by the states. Therefore, we recommend that this clause (3) be modified to require updating in accordance with Section 436.7(a), (b) and (c) and should read as follows:

> "If the Franchisor makes any financial performance representations to prospective franchisees, the franchisor must have a reasonable basis and written substantiation for the representations as of the date of the disclosure document, and as may be revised quarterly pursuant to Section 436.7(b), and must state the representations in the Item 19 Disclosure or in the revisions prepared in accordance with the requirements of Section 436.7(b)."

12. Item 20: Outlets and Franchisee Information [Section 436.5(t)]

Clause (4) under Table 5 requires disclosures by a franchisor if it is "selling an existing franchised outlet." We do not understand what this means. Does it apply only if the franchisor is acting as a broker for a franchisee?

13. Item 23: Receipts [Section 436.5(w)]

The revised receipt requires the franchisor to disclose names, addresses and telephone number of each "franchise seller" offering the franchise. As defined, the term "franchise seller" includes numerous categories of persons, including brokers, which the Staff has deliberately deleted from the disclosures in Items 2 and 3. If the franchisor has a large sales operation, or uses an outside business brokerage firm with numerous sales agents, then the receipt could be quite lengthy if required to reflect all "franchise sellers". We recommend that the receipt remove the reference to "franchise sellers" and only list the franchisor.

14. Updating Requirements [Section 436.7(b)]

Section 436.7(b) requires the franchisor to prepare revisions to reflect any material change in the franchisor or "relating to the franchise business of the franchisor." The quoted language could require disclosures of more information than is required and permitted to be in the franchise disclosure document. We recommend that this language be replaced with the "disclosures included, or required to be included, in the disclosure document."

15. Exceptions [Section 436.8(a)(5)(ii)]

We support the addition of an exception for large franchisees. However, it appears to us that the threshold should be that the franchisee or its parent or any affiliate (rather than "and" its parent or any affiliate) has been in business for at least five years and has a net worth of at least $5 million.

Thank you for your consideration.

Very truly yours,

Kenneth R. Costello

Anthony J. Marks