

December 20, 1999

VIA EXPRESS MAIL

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

Re: 16 C.F.R. Part 436
Franchise Rule Comment

Ladies/Gentlemen:

1. Introduction.

In October 1999 the Commission gave notice of the proposed rule making to amend the trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures." The Commission's announcement sought public comment on the proposed revisions and invited interested parties to submit views and arguments on the proposed changes. This letter provides my comments on the proposed revisions. In accordance with the Commission's request, this letter is accompanied by a 3½ inch computer disk containing this comment letter in Microsoft Word format and labeled with my name and the word processing program.

2. Preliminary Observations.

The Supplemental Information included in the FTC's Notice of Proposed Rulemaking summarized some of the background for the adoption of the Rule in 1979. Some conditions and circumstances that were the basis for adopting the Rule in 1979 have changed in the 20+ years that the Rule has been effective.

In view of significant changes in franchising practices, public awareness of franchising, technological developments and the development of an increasingly global economy, it is

appropriate for the FTC to revise and update the franchise rule. This letter provides comments on the proposed changes.

3. Use of Plain English.

The Commission emphasized the goal of adopting plain English in the new rule. (See proposed rule 436.1(c) and 436.1(q)) and repeatedly seeks to "streamline" the rule. The proposed rule would require franchisors to write their disclosure documents in plain English, consistent with the UFOC guidelines. The Commission's proposed rule should also use plain English as much as possible.

The goal of using plain English should start with the title of the Rule. The title of the Rule should be shortened to "Franchising: Prohibitions and Required Disclosures." Shortening the title will result in significant though possibly unmeasurable, efficiencies as government agencies, lawyers and courts cite and refer to the rule in statutes, legal briefs, articles and court decisions in the future.

There are numerous ways to incorporate more Plain English in the text of the rule, without changing the rule's substance or effect. Enclosed is a print out of the rule with suggested plain English revisions in handwriting. I encourage the Commission to adopt all of these revisions because they will make the Rule easier to understand and use, without changing the Rule's meaning.

4. Franchise Definition.

One of the key definitional elements of a franchise is the existence of a franchise fee, (i.e., "required payments" to the franchisor or its affiliates). 16 C.F.R. Sec. 436.1(g)(3). Under the current rule, payments of a bona fide wholesale price for reasonable amounts of merchandise to be used for resale are not a "required payment." Due to the structure of the proposed rule, there would be an unintentional change in this approach, with the effect that a manufacturer who receives payments of a bona fide wholesale price for reasonable amounts of merchandise to be used for resale could be deemed to be a franchisor that is "exempt" from portions of the rule. As explained in detail in a separate letter that I am submitting, this approach is problematic and should be corrected.

5. Exclusion for De Minimis Sales and for Sales to Sophisticated Investors.

The Commission determined that pre-sale disclosure is still necessary to protect prospective franchisees. However it is appropriate to include thresholds so that transactions under a specified amount do not require disclosures (because they are de minimus), and so that transactions over a specified amount do not require disclosures (because the investors are

presumed to be sufficiently sophisticated to protect themselves). Additionally, it is impractical for the FTC to monitor and regulate an excessively large number of small transactions.

In this regard, the Commission noted that one reason for not making the rule apply to international sales is the view that franchises sold internationally are "to sophisticated investors who are generally represented by counsel or who otherwise can protect their own interests." (Sec. 5(a) of Notice of Proposed Rulemaking). The same premise is a basis not to require disclosure domestically when a franchisee is sophisticated and can protect himself.

As explained in detail in the separate letter that I am submitting, the de minimus minimum amount should be increased substantially above the current \$500 threshold. For now \$1.5 million, as currently proposed by the FTC, is a rational starting point for the upper limit threshold.

6. Business Experience (Proposed Section 436.5(b)).

The current and proposed rule require disclosure of directors, officers and others with management responsibility. For certain franchisors who have large boards of directors or large numbers of officers or both, it is not unusual that there may be a change to the board of directors or officers from time to time. These changes may not be material to prospective franchisees. The rule should be revised to adopt a materiality standard for disclosure of changes to the board of directors or officers of a company with a large number of directors and/or officers, particularly publicly held companies. This will reduce the need for immediate updating of the UFOC due to an addition or departure or other change in the board of directors or officers of a company that is rarely likely to be material to a prospective franchisee.

7. Officers. (Section 436.1(o)).

The commission should not adopt a "de facto" officer definition. This will be a source of disputes as franchisees later try to construct claims that an individual was a de facto officer. This will create a vague standard and invitation for franchisees to make claims against any individual whose performance they are unhappy with in the franchise relationship, by alleging that person was a de facto officer.

Officers are individuals whom the board of directors or other authority of an entity has designated as such. These are the people who are charged with authority for management of the company. De facto officers could arguably include anyone who has influence with a real officer, such as a spouse, sibling, acquaintance or other person whose advice is respected by the officer. This could expose a wide range of people to unfair claims even though they never agreed to serve as officers of a franchisor.

The persons whose backgrounds need to be disclosed are anyone with management authority for the franchise program, whether or not they are officers. The FTC can accomplish this goal by requiring disclosure of anyone with management authority; but not broadening the disclosure to create a new concept of de facto officers.

8. Disclosure of Confidential Settlements.

The rule should permit the omission from the UFOC of details of a settlement that the parties agree to keep confidential. In this regard, the UFOC Guidelines for Item 3 fail to adequately address the strong policy arguments in favor of confidential settlements. Confidentiality promotes settlements, and settlements benefit the parties, the legal system and the economy.

UFOC Item 3 should not present disputing parties with a choice of settling with adverse disclosure for 10 years, or not settling. Requiring disclosure of settlements without regard for the parties' agreement on confidentiality would penalize a disputing franchisee (who is less likely to be able to negotiate a favorable settlement if a franchisor knows the settlement must be disclosed).

The benefit to prospective franchisees is assumed to be fuller disclosure of settlements. However, many franchisors sell franchises with extensive negative dispute resolution disclosures. There are also franchisors with little or no litigation to disclose, who still are not able to sell any or many franchises. Some of the nation's most prominent franchises have many pages of litigation disclosures in their UFOC yet they are still able to sell many franchises.

The opportunity for confidentiality is often an important dynamic to resolve a dispute. A benefit of arbitration, for example, is that it provides privacy.

Another problem with requiring disclosure and precluding confidentiality is that as soon as litigation or arbitration is filed, the resolution of a material action cannot be confidential. However, there should not be a difference between a newly filed arbitration or lawsuit and a mediated dispute or non-mediated dispute.

Also, the disclosure rule does not provide for circumstances when a court imposes a gag order or otherwise orders the settlement to be confidential. In those circumstances, the franchisor faces the untenable choice of violating the court order in order to comply with the rule, or violating the rule in order to comply with the court order.

For all these reasons the rule should be revised to allow franchisors to maintain the confidentiality of confidential settlements. An alternative is to adopt a materiality standard for disclosure of confidential settlements. The franchisor should be permitted to disclose material facts about confidential settlements, which would permit generalized disclosure. Also the

franchisor should be permitted to disclose material facts about confidential settlements in the aggregate, so that the franchisor could make the disclosure about a group of cases, without violating the confidentiality of any one or more cases. For example, "we have settled 10 cases with confidentiality agreements. In each of these cases we made payments to the franchisee in the mid five figure range."

9. Disclosure of Franchisor Initiated Litigation.

The commission should not require disclosure of franchisor initiated litigation. This type of litigation does not necessarily provide a material fact that is relevant to a prospective franchisee. It will enlarge the already lengthy litigation disclosures and create a risk of misleading franchisees by suggesting there is more litigation than there is.

However, if the commission elects to adopt such a rule then, to reduce legal compliance costs and uncertainty, the commission should include two bright line safe harbors.

A. Franchisor initiated litigation should be deemed to be non-material and not require disclosure if it involves only a certain (small) number or (small) percentage of franchises in the system or involves only collection of a small amount of money.

B. Franchisor initiated litigation should be deemed to be material and require disclosure if it involves more than a specified (large) number or (large) percentage of franchisees in the system.

This approach narrows the gray area where a franchisor would be required to make judgments, subject to after-the-fact second guessing by a court or government agency, whether the disclosures were material, and provides a franchisor the opportunity to benefit from a safe harbor in any or all cases by making disclosure of franchisor initiated litigation.

Where a franchisor has many cases of the same kind or nature, the FTC should also permit disclosure of a description of the type of case, accompanied by a list of the case titles, case numbers and status. Pages and pages of repetitive disclosures about a particular type of litigation are not helpful to a prospective franchisee.

10. Bankruptcy Disclosures (Proposed Section 436.5(d)).

The Commission should not enlarge the length of time for which bankruptcy disclosures are required. There are several reasons for this view.

A. After five years, bankruptcy information is not relevant to prospective franchisees. Five years following a bankruptcy, an individual or business's circumstances can dramatically change. A bankruptcy more than five years old is not a predictor of anything.

B. It is increasingly difficult to obtain records of bankruptcy filings that are more than five years old. This is because individuals who experienced a bankruptcy tend not to retain these records. Courts tend to place the records in off-premises archival storage where substantial lengths of time are required before the records can be obtained.

C. Some franchise companies elect not to hire someone whose prior bankruptcy must be disclosed in the UFOC. By enlarging the length of time that a bankruptcy must be disclosed, the FTC will be rendering these people unemployable for longer period of time.

For these reasons, the Commission should reduce the length of time that a bankruptcy must be disclosed, to five years.

11. Initial Fee (Proposed Section 436.5(e)).

As a practical matter, it is prospective franchisees who wish to negotiate initial franchise fees, not franchisors. Franchisors generally prefer not to negotiate initial franchise fees. Since the purpose of the rule is disclosure, and the FTC has stated that it is not its purpose to regulate the substantive terms of the franchise relationship, the rule should be modified to make clear that franchisors can negotiate with a prospective franchisee over the initial franchise fee without potentially violating the rule. However the rule should also permit a franchisor to disclose that it does or does not negotiate the initial franchise fee, and if it negotiates, permit disclosure of conditions that may affect the negotiation.

12. Financing (Proposed Section 436.5(j)).

The rule should permit negotiating financing terms as well. By way of comparison, a franchisee is able to negotiate with any lender. The franchisee should be able to negotiate with the franchisor as well. The franchisor should be expressly permitted to disclose a range within each of the categories in the Item 10 table. The Commission may wish to provide that if a franchisor negotiates financing terms, the franchisor must disclose that there are other sources of financing, such as banks, which the franchisee should consider.

13. Contracts (Proposed Section 436.5(v)).

The rule should state expressly that the contracts to be attached do not include forms of negotiated settlement agreements. These are unknown when the UFOC is prepared, and the terms of each settlement are unique. No one can know what they will contain until an actual

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dispute is resolved. A franchisor should not be required to attach an agreement that cannot be attached.

14. Exemption for Membership in a Cooperative Association.

The Commission should retain the express exemption for membership in a cooperative. State officials have, on occasion, investigated whether memberships in cooperatives constituted franchises. It has been necessary to refer to the FTC's exclusion for such memberships to demonstrate to the state that these were not intended to be viewed as franchises. Without this express exemption, states and the FTC may view memberships in cooperatives as franchises, though this is not the intent of the change. Therefore, this important exemption should be retained.

15. Disclaimer.

The views in this letter are those of the author and do not purport to represent an opinion or views of Arter & Hadden LLP.

Yours truly,

David Gurnick
of ARTER & HADDEN LLP

DG/lrc
Enclosures