

December 20, 1999

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**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 – Definitions of "Franchise" and "Required Payment"

Ladies/Gentlemen:

In October 1999, the Federal Trade Commission published a Notice of Proposed Rulemaking ("NPR") in which it proposed to amend the Trade Regulation Rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (the "Current Rule"). (The proposed amendment will hereafter be referred to as the "Proposed Rule.") This letter provides comments on the Proposed Rule's definitions of "franchise" and "required payment."<sup>1</sup>

This letter points out ambiguities and inconsistencies in those definitions and explains how the Proposed Rule inappropriately (and inadvertently) changes long-standing Commission policy by broadening the definition of "franchise." This letter suggests revisions to the Proposed Rule that will eliminate those ambiguities and inconsistencies and will conform the definition of "franchise" to long-standing policy. This letter also proposes that the "minimal investment" exemption level, which has not been adjusted since the Current Rule was adopted in 1979, be increased.

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<sup>1</sup> This letter includes citations to the Current Rule and to the "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures; Promulgation of Final Interpretive Guides," 44 Federal Register 49966 (August 24, 1979) (the "Interpretive Guides").

In accordance with the Commission's request, this letter is accompanied by a 3½" computer disk containing this comment letter in Microsoft Word format and labeled with my name and the word processing program.

The Current Rule's Definition of "Franchise"

Under the Current Rule, the definition of "franchise" includes the following elements:

- (i) distribution of goods or services associated with the franchisor's trademark,
- (ii) significant control of, or significant assistance to, the franchisee's method of operation, and
- (iii) required payments by the franchisee to the franchisor.<sup>2</sup>

The Current Rule provides that the "required payments" element is met if the franchisee is required, as a condition of obtaining or commencing the franchise operation, to make a payment or commitment to pay to the franchisor or an affiliate of the franchisor.<sup>3</sup> The intent of the "required payments" element is to capture all sources of revenue which the franchisee must pay to the franchisor (or an affiliate of the franchisor) **"for the right to associate with the franchisor and market its goods or services."**<sup>4</sup> In other words, the Commission's intent is to capture all "hidden franchise fees."<sup>5</sup>

With respect to inventory purchases, the Interpretive Guides make clear that **payments for reasonable amounts of inventory purchased at a bona fide wholesale price are not considered "required payments"** under the Current Rule. Specifically, the Commission's policy is as follows:

[T]he Commission will not construe as "required payments" any payments made by a person at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale. The Commission will construe "reasonable amounts" to mean amounts not in excess of those which a reasonable businessman normally

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<sup>2</sup> Interpretive Guides, 44 Federal Register at 49968.

<sup>3</sup> 16 C.F.R. § 436.2(a)(2).

<sup>4</sup> Interpretive Guides, 44 Federal Register at 49967 (emphasis added).

<sup>5</sup> Id.

would purchase by way of a starting inventory or supply or to maintain a going inventory or supply.<sup>6</sup>

This policy recognizes that payments for reasonable amounts of inventory at a bona fide wholesale price are not payments for the right to associate with the franchisor and are not hidden franchise fees.

Thus, under the Current Rule, if a distributor is not required to make any payments to his or her supplier (or an affiliate of the supplier) other than the purchase of reasonable amounts of inventory at a bona fide wholesale price, then the distributorship is not a "franchise." That distributorship would therefore not be covered by the Current Rule.

Further, the Current Rule completely excludes from its coverage any relationship in which the total of the "required payments" made during a period from any time before to six months after commencement of operations is less than \$500.<sup>7</sup> This provision "reflects the Commission's policy determination that a significant financial risk on the part of the franchisee is a necessary element of a franchise."<sup>8</sup>

The Current Rule, then, does not apply to a distributorship in which the total amount the distributor is required to pay to the supplier (or to an affiliate of the supplier) before the distributorship commences operation or during the first six months of operation is less than \$500, excluding payments for reasonable amounts of inventory at a bona fide wholesale price. When the Commission adopted the Current Rule, it recognized that such a distributorship: (1) does not expose the distributor to the type of risk with which franchise laws are concerned, and (2) is not a "franchise" in any commonly accepted sense of that term. Those facts are as true today as they were when the Current Rule was adopted.

However, the Proposed Rule's treatment of such a distribution arrangement differs from that of the Current Rule in several important respects.

#### The Proposed Rule's Definitions of "Franchise" and Related Terms

Subsection 436.1(g) of the Proposed Rule contains the following definition of "franchise":

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<sup>6</sup> Id.

<sup>7</sup> 16 C.F.R. § 436.2(a)(3)(iii).

<sup>8</sup> Interpretive Guides, 44 Federal Register at 49968.

- (g) *Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller represents, orally or in writing, that:
- (1) The franchisee obtains the right to operate a business or offer, sell, or distribute goods, commodities, or services that are identified or associated with the franchisor's trademark;
  - (2) The franchisor:
    - (i) Exerts or has authority to exert a significant degree of continuing control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, or marketing plan; or
    - (ii) Provides significant assistance in the franchisee's method of operation (*e.g.*, the franchisee's business organization, promotional activities, management, or marketing plan), extending beyond the start of the business operation. Promotional assistance alone, however, will not constitute "significant" assistance in the absence of other forms of assistance; and
  - (3) As a condition of obtaining or commencing operation of the business, the franchisee is required by contract or by practical necessity to make a payment, or a commitment to pay, to the franchisor or a person affiliated with the franchisor.<sup>9</sup>

Thus, the Proposed Rule's definition of franchise, like the definition in the Current Rule, includes three elements: (1) association with trademark, (2) significant control or assistance and (3) required payments to the franchisor or an affiliate. Unfortunately, the Proposed Rule's definition is unclear and confusing in several respects.

First, Subsection 436.1(u) of the Proposed Rule contains a separate definition of "required payment" as follows:

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<sup>9</sup> NPR, 64 Federal Register at 57322.

. . . all consideration that the franchisee must pay to the franchisor or its affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise.<sup>10</sup>

The term "required payment," however, is not actually used in the Proposed Rule's definition of franchise. Also, the language of the required payment definition differs from the language of the third element of the franchise definition. For example, the definition of required payment refers to "affiliate" and "operation of a franchise," while the third element refers to "a person affiliated with the franchisor" and "operation of the business."

Second, although the Proposed Rule defines "affiliate" in Subsection 436.1(b), as noted above the definition of franchise does not actually use that term but instead refers to "a person affiliated with the franchisor."

Subsection 436.1(g)(1) (the association with trademark element) is also not clearly drafted. That subsection could be read as only requiring that the franchisee "obtains the right to operate a business," regardless of whether a trademark is involved.<sup>11</sup>

Additional interpretation problems are presented by the proposal that a franchise will be deemed to exist if the franchise seller represents that the business relationship has the three characteristics of a franchise, regardless of whether those characteristics exist. The NPR indicates that this provision will protect franchisees in cases where the representations prove to be incorrect, and that the definition should apply "regardless of any failure by the franchisor to perform."<sup>12</sup> Whether or not that rationale has merit with regard to proposed Subsection 436.1(g)(1) (association with trademark) or proposed Subsection 436.1(g)(2) (providing control or assistance), the rationale is clearly inapplicable to the third element of the definition (proposed Subsection 436.1(g)(3)--required payments). The third element of the definition of franchise does not involve any performance by the franchisor, and there is nothing for the franchise seller to "represent" with respect to that element.<sup>13</sup>

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<sup>10</sup> NPR, 64 Federal Register at 57322.

<sup>11</sup> I note in this regard that the phrase "operate a business . . . that are identified or associated with the franchisor's trademark" is grammatically incorrect.

<sup>12</sup> NPR, 64 Federal Register at 57298.

<sup>13</sup> If for some reason a supplier erroneously "represents" that a fee will be required when in fact no fee is required, the other party has not been harmed. In such a case that party does not incur the "significant financial risk" that is a necessary element of a franchise. See Interpretive Guides, 44 Federal Register at 49968.

These ambiguities and inconsistencies in the defined terms are sure to lead to confusion in the application of the Proposed Rule. Moreover, the definitions would inappropriately extend the franchise rule's coverage to distribution arrangements that the rule was never intended to cover.

The Proposed Rule Would Inappropriately Broaden the Definition of "Franchise"

The Proposed Rule would cover and regulate distribution arrangements that have not previously been covered or regulated by the Current Rule or by state franchise laws. This extension of coverage would result primarily from the fact that the Proposed Rule's definitions of "franchise" and "required payment" do not contain an exclusion for inventory purchases. Thus, payments for reasonable amounts of inventory purchased at a bona fide wholesale price could be deemed to trigger application of the Proposed Rule. This change would overturn the Commission's twenty-year-old policy on sales of inventory at bona fide wholesale prices and would also be inconsistent with all state franchise disclosure laws.<sup>14</sup>

The Proposed Rule does include an exemption for inventory payments, but this provision only exempts the relationship from the disclosure requirements. The exemption is currently contained in proposed Subsection 436.9(a), which provides as follows:

The disclosure requirements of sections 436.2-436.8 shall not apply if the franchisor can establish any of the following:

- (a) The total of the required payments to the franchisor or an affiliate that are made any time before to within six months after commencing operation of the franchisee's business is less than \$500, not including payment for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale.<sup>15</sup>

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The NPR states that Subsection 436.9(a) of the Proposed Rule "does not change Commission policy, but makes clear that traditionally non-franchised businesses can sell

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<sup>14</sup> See Interpretive Guides, 44 Federal Register at 49967; Cal. Corp. Code § 31011(a); Haw. Rev. Stat. § 482E-2; 1996 Ill. Comp. Stat. 705/3(14); Ind. Code § 23-2-2.5(1)(i); Md. Code Ann., Bus. Reg. § 14-201(g)(3)(i); Mich. Comp. Laws § 445.1503(1)(a); Minn. Stat. § 80C.01(9)(a); N.Y. Gen. Bus. Law § 33-681.7(a); N.D. Cent. Code § 51-19-02(6)(a); R.I. Gen. Laws § 19-28.1-3(h)(3); S.D. Codified Laws § 37-5A-4(1); Va. Code Ann. § 13.1-559-(g)(i); Wash. Rev. Cod. § 19.100.010(12)(a); Wis. Stat. § 553.03(5m)(a).

<sup>15</sup> NPR, 64 Federal Register at 57345.

inventory without the fear of triggering the Rule's minimum payment requirement."<sup>16</sup> In fact, however, that subsection and the definitional provisions discussed above would constitute a significant (albeit unintentional) change in Commission policy. The Proposed Rule should be revised so that it does not effect such a change—a change which the Commission obviously did not intend and for which there would be no rational basis.

As explained above, the Current Rule does not apply to a distributorship in which the total amount the distributor is required to pay to the supplier (or to an affiliate of the supplier) before the distributorship commences operation or during the first six months of operation is less than \$500, excluding payments for reasonable amounts of inventory purchased at a bona fide wholesale price. Although such a distributorship would be exempt from the Proposed Rule's disclosure requirements, the distributorship could nonetheless be deemed a "franchise" under the Proposed Rule. Indeed, because the Proposed Rule does not include an appropriate exclusion for inventory purchases, under the Proposed Rule almost any distributorship that involves a trademarked product would be subject to possible characterization as a "franchise."

Thus, contrary to the Commission's objective stated in the NPR, a "traditionally non-franchised business" that sells inventory to distributors could be covered by the Proposed Rule. Specifically, the business could be subject to proposed Section 436.10.<sup>17</sup> Such regulation is entirely inappropriate because, as the Commission recognizes in the Interpretive Guides, "a significant financial risk on the part of the franchisee is a necessary element of a franchise." If the only material payments to the supplier or its affiliates are payments for inventory at a bona fide wholesale price, then the supplier isn't selling a franchise and should not be regulated under the franchise rule.

It is also important to note that compliance with proposed Section 436.10 by such a supplier would be untenable. For example, proposed Subsection 436.10(d) would prohibit dissemination of "any financial performance representation" unless "the representation is included in Item 19 of the franchisor's disclosure document." The "exempt" supplier, however, has no such disclosure document. The practical effect of this provision would be to prohibit the supplier from disclosing any information regarding potential financial performance to prospective distributors.

Similarly, proposed Subsection 436.10(a) would prohibit the supplier from making "any claim or representation, orally, visually, or in writing, that contradicts the information required to be disclosed by the Rule." To comply with that Subsection, the supplier presumably would have

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<sup>16</sup> NPR, 64 Federal Register at 57320.

<sup>17</sup> NPR, 64 Federal Register at 57346.

to become fully familiar with the Rule's disclosure requirements (from which the supplier is supposedly exempt) and avoid saying anything to a prospective distributor that might "contradict" a prescribed disclosure.

Proposed Section 436.10 cannot sensibly be applied in these situations, which underscores the fact that the NPR's deviation from the Commission's long-standing policy of excluding "traditionally non-franchised" businesses was inadvertent. Certainly there is no justification for applying that Section to such a business.

The Proposed Rule should be revised to exclude such a business from its coverage. As explained below, the Proposed Rule's "minimal investment" level also should be revised.

#### The \$500 "Minimal Investment" Level Is Outdated and Unreasonably Low

The minimal investment exclusion reflects the fact that "significant financial risk" is a necessary element of a franchise.<sup>18</sup> When the Commission adopted the Current Rule in 1979, it determined that an investment of less than \$500 did not represent a significant risk. The Commission recognized that there is no justification for regulation in the absence of such risk.<sup>19</sup>

The Commission should now recognize that the passage of 20 years has rendered the \$500 limit unreasonably low. The NPR's discussion of proposed Subsection 436.9(e) (the sophisticated investor exemption) acknowledges that the monetary thresholds in that Subsection may subsequently become too low. Accordingly, the Commission proposes to adjust those thresholds periodically.<sup>20</sup>

The minimal investment amount should also be adjusted. The \$500 limit is outdated and does not serve its purpose of exempting arrangements that do not involve significant financial risk. The limit should therefore be raised, to at least \$1,000.

#### Suggested Changes to the Proposed Rule

To correct the problems outlined above, the following changes should be made to the Proposed Rule.<sup>21</sup>

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<sup>18</sup> Interpretive Guides, 44 Federal Register at 49968.

<sup>19</sup> Id.

<sup>20</sup> NPR, 64 Federal Register at 57321.

<sup>21</sup> A "redlined" version of these definitions is attached to this letter as Exhibit A. The redlined version shows the specific additions and deletions that I suggest be made to the proposed Rule.

**Proposed Subsection 436.1(g) (the definition of "franchise") should be revised to read as follows:**

- (g) *Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which:
  - (1) The terms of the offer or contract specify, or the franchise seller represents, orally or in writing, that:
    - (a) The franchisee obtains the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, commodities or services that are identified or associated with the franchisor's trademark; and
      - (b) The franchisor:
        - (i) Exerts or has authority to exert a significant degree of continuing control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, or marketing plan; or
        - (ii) Provides significant assistance in the franchisee's method of operation (*e.g.*, the franchisee's business organization, promotional activities, management, or marketing plan), extending beyond the start of the business operation; provided, however, that promotional assistance alone will not constitute "significant" assistance in the absence of other forms of assistance; and
    - (2) The total of the required payments by the franchisee to the franchisor or an affiliate that are made any time before to within six months after the franchisee commences operations exceeds \$1,000.

**Proposed Subsection 436.1(u) (the definition of "required payment") should be revised to read as follows:**<sup>22</sup>

- (u) *Required payments* means all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise, but not including any payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale.

**Proposed Subsection 436.9(a) (the minimal investment exemption) would then be deleted.**

Thank you for your consideration of these comments. Please note that the views expressed 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

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<sup>22</sup> Note that I propose changing the defined term from "required payment" to "required payments." Proposed Subsection 436.9(a) uses the term "required payments." The Interpretive Guides also use the plural form of the term. See 44 Federal Register at 49967.