

October 22, 2004

FILED ELECTRONICALLY

Federal Trade Commission

Steven Toporoff, Attorney

Eileen Harrington, Associate Director,
Division of Marketing Practices, and

J. Howard Beales, III, Director,
Bureau of Consumer Protection

Re: Comments on Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule, Disclosure Requirements and Prohibitions Concerning Franchising (16 CFR Part 436), Dated August 2004

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

Our law firm represents both franchisors and franchisees in the course of structuring franchise programs, preparing and registering franchise contracts and disclosure documents, the negotiation and transfer of franchises, and the resolution of franchise disputes. In evaluating the proposed revised Rule (the "Rule"), we have tried to balance the disclosure burdens being placed on franchisors against the real world value of the disclosures to a prospective franchisee, based on our experiences with our clients. (The comments in this letter are ours, and do not necessarily reflect the views of our clients.) We also believe that a few points in the Rule should be clarified (either in the language of the Rule itself, or in the Compliance Guides) to provide more certainty about exactly what is required (and what is not). (References to page numbers are to the Staff Report (the "Report") as published by Commerce Clearing House in its special handout.)

1. Definition of "Action" – Known Actions [Section 436.1(a)]

We agree that franchisors should disclose known actions, even if they have not been served on the franchisor. We recommend, however, that the Commission clarify in the Compliance Guides that the franchisor is not under any affirmative obligation to undertake searches of court records to determine if any actions have been filed against the franchisor that have not been served on the franchisor, and that are not otherwise known to the franchisor.

2. Definition of "Disclose" – Font Size [Section 436.1(d)]

Footnote 59 of the Report recommends that the Compliance Guides require disclosures to be made in 12 point upper and lower case type. We believe that documents with text written in 11 point type and charts and footnotes in 10 point type are very readable, especially when

more modern "straight" fonts such as Arial and Tahoma are used, rather than the more traditional "curly" fonts such as Times New Roman or Courier. For example, this letter is written in Arial 11 point, as were all the papers for the recent ABA Franchise Forum in Vancouver; and the chart, "Attachment A: Comparison of UFOC and Proposed FTC Franchise Rule Disclosure Requirements," that was part of the handout for the Forum workshop on the Report, was written in Arial 10 point. Charts and tables are extremely useful to prospective franchisees, but they become hard to use and follow if they do not fit across one page, which is extremely hard to do for charts with eight or nine columns, as is proposed for the new charts in Item 20. Finally, permitting a smaller font size will reduce the size and cost of paper disclosure documents for franchisors, and also for franchisees and their advisors who receive an electronic disclosure and wish to print out a hard copy for reference.

3. Definition of "Franchise Seller" – Brokers [Section 436.1(i)]

The proposed explanation of a broker to be included in the Compliance Guides should be modified so that it reads: ". . . a broker is a person who: (1) is under a contract with the franchisor relating to the sale of franchises; (2) receives compensation from the franchisor related to the sale of franchises; and (3) arranges franchise sales by assisting prospective franchisees in the sales process." The proposed language is consistent with the explanation in footnote 175 of the Report. This language will narrow the definition to exclude existing franchisees and others who may have contracts unrelated to franchise sales with the franchisor, and to whom the franchisor may wish to pay some gratuity for a lead referral or time spent answering a prospect's questions.

4. Definition of "Parent" – [Section 436.1(m)]

We suggest that for clarification a second sentence be added to the definition of "parent" stating: "A parent entity is an affiliate, but is separately defined because certain requirements apply to parent entities but not to other types of affiliates." Alternatively, it may be sufficient to add this explanation to the Compliance Guides.

5. Definition of "Predecessor" – [Section 436.1(p)]

We support excluding from the definition anyone from whom the franchisor obtained a trademark or trade secrets license.

6. Definition of "Required Payment" – [Section 436.1(s)]

We agree that the definition of required payments should not generally include payments to third parties. We do, however, recommend one exception – where payments are made by a franchisee directly to a third party in satisfaction of what would otherwise be a payment obligation of the franchisor or its affiliate. For example, if the franchisor has entered into a lease or contracted for a yellow pages ad, and the franchisee assumes that obligation and makes the payments, thus relieving the franchisor of its payment obligation. The proposed definition would read: "Required payment means all consideration that the franchisee must pay to the franchisor or an affiliate, or to a third party to whom the franchisor or an affiliate is previously obligated for the payment, either by contract or"

7. Obligation To Furnish Documents – [Section 436.2]

We strongly support allowing franchisors to make disclosures electronically or by electronic media, and the substitution of 14 calendar days for 10 business days.

We also strongly support the substitution of seven calendar days for five business days, and the proposed Rule change that would require disclosure of a revised franchise agreement seven days before the franchisee signs only if the franchisor unilaterally and materially alters the terms and conditions, and would not require disclosure where changes result solely from negotiations initiated by the prospective franchisee. We do recommend, however, that the language of the Rule be revised to apply not only to the franchise agreement, but also to changes to any related agreements. We suggest the following language:

"For any franchisor to alter unilaterally and materially the terms and conditions of the basic franchise agreement or any related agreements attached to the disclosure document without furnishing the prospective franchisee with a copy of each revised agreement, at least seven days before the prospective franchisee signs the revised agreement. Changes to the agreements that result solely from negotiations initiated by the prospective franchisee do not trigger this seven-day period."

In our experience, when prospective franchisees ask for changes, typically there is some give and take to reach a compromise, so that there may be some benefit to the franchisor as well. For this reason, we also recommend that the Compliance Guides clarify that no disclosure is required where changes result from negotiations initiated by the prospective franchisee even if some of the negotiated changes favor the franchisor.

8. Table of Contents – Changes to Item Names [Section 436.4]

We suggest that the name of Item 5 be changed to "Initial Payments to the Franchisor." It is shorter, and makes it clearer that all payments (and not just franchise fees) are included. We support all of the other Item name changes.

9. Item 2: Business Experience – Individuals Who "Control" the Franchisor [Section 436.5(b)]

The Report states in the third paragraph of page 101 that:

"[W]e believe a franchisor should identify all individuals who control the franchisor, regardless of any formal title. This is true even if the individual is an officer of a parent or an affiliate. [Footnote omitted.] As long as the individual exercises control over the franchisor, then his or her background information should be disclosed, no less than officers of the franchisor itself. . . ."

We are concerned that this language could be interpreted to require disclosure about the owners of a franchisor who own a controlling interest in the franchisor. Please make it clear in the Compliance Guides that disclosure is not required if an owner is not a director,

trustee, general partner, or principal officer of the franchisor and does not occupy a similar status or perform a similar function.

We support the deletion of disclosure about all parent officers, directors, *etc.*, from Item 2.

10. Item 2: Business Experience – Subfranchisors [Section 436.5(b)]

Since the definition of "franchisor" includes "subfranchisors," we believe the words "and subfranchisors" should be deleted from the last sentence of Item 2.

We strongly support the elimination of all disclosures about franchise brokers under the Rule.

11. Item 3: Litigation – Guarantee from Affiliate [Section 436.5(c)]

To be consistent with Item 21, which permits any affiliate of the franchisor (not just a parent) to guarantee the franchisor's obligations, change the references in (1) and (2) from "a parent" to "an affiliate."

12. Item 3: Litigation – Franchisor-Initiated Litigation [Section 436.5(c)]

We propose that a statement be added in connection with the report of franchisor-initiated litigation explaining that this section of the disclosure document is limited to only certain types of actions and only updated annually. Otherwise, the report may be misleading by implication. We suggest that the following language be inserted before the summaries:

"Material actions by [name of franchisor] against its franchisees that were pending at any time during the last fiscal year are summarized below. These actions involved the status of the franchise relationship directly related to the operation of the franchised business. This summary does not include actions involving third parties, or actions begun after the end of the last fiscal year."

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

Since the bankruptcy disclosure applies to all affiliates (and not just to certain affiliates), the reference to "any parent" should be deleted because a parent entity is an affiliate.

14. Item 6: Other Fees – Payments to Third Parties [Section 436.5(f)]

We believe the language in Item 6 of the Rule is too broad with respect to payments to third parties. For example, most franchise agreements "require" franchisees to lease premises to operate the franchised business, obtain all necessary licenses, and operate the franchised business in compliance with all applicable laws. All of the payments to do these things are technically "required," but they are generally applicable to all businesses, and the franchisor does not control when they are made, to whom they are made, or what the amount is. There is

not likely to be any disclosure about these types of expenses that a franchisor could make that would be particularly helpful to a prospective franchisee.

On the other hand, we believe disclosures about third party payments would be useful where the franchisor dictates who the franchisee must purchase from (*e.g.*, approved and designated suppliers), or where the franchisor determines the time when the franchisee must make expenditures (*e.g.*, the franchisee must remodel and upgrade to then current standards every five years), or when the franchisor indirectly benefits from franchisee purchases (*e.g.*, when beverage suppliers make contributions to an advertising coop or sponsor franchisee conventions).

Finally, we suggest that the broader term "payments" be used rather than "fees."

We propose that the disclosure requirement be rewritten as follows:

"Disclose, in the tabular form shown below, all other payments that the franchisee must make 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 to pay directly to a third party if the franchisee makes payments to a third party supplier designated or approved by the franchisor, or if the franchisor directly or indirectly determines the timing or amount of the payments to the third party, or if the franchisor or its affiliates or any cooperative or other group affiliated with the franchise system receives any revenues or is relieved of any financial obligation as a result of the franchisee's purchases from the third party. Include any formula used to compute the fees."

15. Item 11: Franchisor's Assistance, Advertising, Computer Systems, and Training – Operating Manual [Section 436.5(k)]

The Report suggests in footnote 442 that franchisors may opt out of disclosing the table of contents for their operating manual if they provide a prospective franchisee with the "opportunity" to review the manual. Our concern is that the "opportunity" may be impractical and prospective franchisees may not be able to take advantage of it. Currently, franchisors must either include the table of contents in their disclosure document, or make sure that prospective franchisees actually review the manual. Franchisors who do not want to disclose the table of contents of their manual can make the necessary arrangements for prospects to review the manual. We believe that the current requirement is a good one, and recommend keeping it.

16. Item 12: Territory – Warning About No Exclusive Territory [Section 436.5(l)]

While we have no problem with the concept of inserting a warning where the franchisor does not grant an exclusive territory, the proposed language does not exactly fit all situations. For instance, many franchisors grant "protected territory rights" under which the franchisee has certain protections (*e.g.*, no other retail locations will be established in the territory), but the area is not really "exclusive" because the franchisor and other franchisees can sell or service customers in the area. In this example, it would not be correct to say that franchisees would

face competition from other outlets, but some warning would be appropriate. In this example, the warning might say:

"You will not receive an exclusive territory. You may face competition from us or other franchisees in your area, or from other channels of distribution or competitive brands that we control."

There does not seem to be any "one size fits all" warning language, so we suggest that the Rule permit the use of the suggested language, or language modified to the extent necessary to reflect the terms of the franchisor's particular territory rights.

17. Item 13: Trademarks – Warning About No Registration [Section 436.5(m)]

In footnote 472, the Report proposes new warning language to be used if the franchisor's principal trademark is not federally registered. There are two problems with the proposed language. First, the trademark may be registered with a state, although not registered federally, and consequently it would not be correct to say that the trademark is "unregistered." Second, if a franchisee were forced to change to an alternative mark, the franchisee's costs might be increased, but those costs might well be capital expenditures as opposed to operating costs. For these reasons, we propose the following substitute language:

"We do not have a federal registration for our principal trademark. Therefore, our right to use the trademark may be challenged. If so, franchisees may have to change to an alternative trademark, which may increase your costs."

18. Item 19: Financial Performance Representations [Section 436.5(s)]

We strongly support the elimination of cost information alone as constituting a financial performance representation, and the elimination of the requirement that historical financial performance representations be prepared in accordance with GAAP. We also support the option of making financial performance representations based on sub-group data.

19. Item 20: Outlets and Franchisee Information – Terminations and Reacquisitions [Section 436.5(t)]

We strongly support the proposed five separate charts in this Item and the elimination of "double counting." Paragraph (H) to the directions for Table No. 3 (Status of Franchised Outlets) should be corrected by deleting the words "as one of the franchisor's outlets".

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

We recommend that trademark-specific franchisee associations that are not created, sponsored or endorsed by the franchisor, that ask to be included in the franchisor's disclosure document be included if the association is a corporation, partnership, limited liability company or any other form of entity formally created under state law. We do not believe there is any reason to limit the right to ask for disclosure to just those organizations that have incorporated.

Since some franchisors are able to update their disclosure documents shortly after their fiscal year ends, we suggest that the time period for a trademark-specific franchisee association to request that it be included in the disclosure document be shortened to 30 days. This should not put any undue burden on an association that wishes to be included.

21. Item 21: Financial Statements – [Section 436.5(u)]

We strongly support the elimination of the original proposed requirement that the financial statements of the franchisor's parent be included in the disclosure document in all cases.

22. Updating Requirements – [Section 436.7(a)]

We support the extension of the annual updating deadline from 90 to 120 days. We suggest, however, that the deadline be expressed as four months rather than 120 days, because that is how people interpret 120 days – sometimes to their detriment. For example, in leap years 120 days falls on April 29th, or if the franchisor's fiscal year end is June 30th, 120 days falls on October 28th. We recommend the following language:

"All information in the disclosure document shall be current as of the close of the franchisor's most recent fiscal year. By no later than the last day of the fourth calendar month after the close of the franchisor's fiscal year, the franchisor shall prepare a revised disclosure document, after which a franchise seller may distribute only the revised document and no other disclosure document."

23. Exemptions – New Franchisee Exemptions [Section 436.8(a)]

We strongly support the addition of three new exemptions for large investments, large and experienced franchisees, and insiders. We suggest two minor revisions to the exemption language however.

First, in Section 436.8(a)(5)(ii) [the large sophisticated franchisee exemption], since a parent is an affiliate, the language should be revised so that this provision reads:

"The franchisee (and any affiliates) is an entity that has been in business for at least five years and has a net worth of at least \$5 million."

Second, with respect to Section 436.8(a)(6) [the insider exemption], the owners of the franchisee will not necessarily be purchasing their ownership interests at the same time that the franchise is acquired. Therefore, we suggest substituting the word "owners" for the word "purchasers" to avoid any implication that concurrent purchases are required.

24. Additional Prohibitions – Financial Performance Representations in General Media [Section 436.9(c)]

We believe that franchisors should be free to make truthful statements about their financial performance in the general media (including over the internet), and that those

representations should not be deemed to be financial performance representations to prospective franchisees unless a franchise seller directs a prospective franchisee to such representations, or provides copies to a prospective franchisee, or otherwise uses such representations in the course of selling franchises.

25. Additional Prohibitions – Disclaimers and Contract Negotiations [Section 436.9(i)]

Contrary to the statement in the second sentence of the first full paragraph on page 261 of the Report, Item 17 of the disclosure document does require the franchisor to summarize (as well as reference) the terms of the contracts.

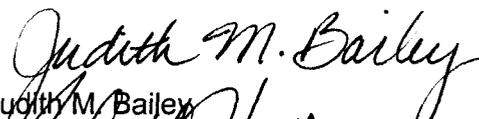
26. Legality of Practices – [Section 436.10(a)]

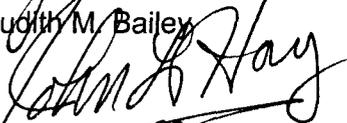
The report states in the last paragraph of Section XI.B.1 that "the prohibition against including additional materials, other than non-preempted state law requirements, would bar a franchisor from expanding its disclosures to include even additional material information." This statement is inconsistent with the recommendation in Section VII.C.3 of the Report (in the first paragraph on page 214) that "the Commission clarify in the Compliance Guides that a franchisor can add brief footnotes or other clarifications to ensure that a required disclosure is complete and not misleading." We strongly recommend that Section XI be modified to conform with Section VII. Franchisors should not be forced to hand out a misleading document and hope that a supplemental disclosure is delivered and read simultaneously.

Finally, we strongly support the adoption of a separate rule regulating the sale of business opportunities.

Thank you very much for your consideration of these suggestions.

Very truly yours,
Gust Rosenfeld P.L.C.


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