I. INTRODUCTION

Certain business arrangements that satisfy the federal franchise definition are nevertheless exempt from coverage under the Amended Rule for policy considerations explained in the FTC’s rulemaking record.

The Amended Rule retains all four exemptions found in the Original Rule—the exemptions for (1) minimum payment; (2) fractional franchises; (3) leased departments; and (4) oral contracts—and added four new ones—one for franchise sales involving petroleum marketers and three different categories of “sophisticated investors,” including

1. For purposes of the Amended Rule, a “franchise” is defined as follows:

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 promises or represents, orally or in writing, that:

1. The franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark;

2. The franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and

3. As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.


exemptions for large franchisee investments, large franchisees with sufficient net worth and prior experience, and insiders.

Of all of the changes the FTC made to the Original Rule when it overhauled it in 2007, the additions of the large franchisee and large investment exemptions are the most important in that they scale back federal regulation of franchise sales from what had been one-size-fits-all coverage. The FTC also improved the Original Rule organizationally by placing the eight exemptions in a new separate “exemptions” section in the Amended Rule where previously exemptions were buried in the Original Rule’s definition of “franchise.”

Exemptions are different from exclusions. The former covers arrangements that qualify as a franchise under the federal franchise definition, but for public policy reasons are relieved from regulation, while the latter are not franchises. The distinction is worth noting because while the Amended FTC Rule did not modify the franchise definition in the Original Rule, it did delete the Original Rule’s four exclusions for non-franchise relationships involving (1) employer-employees and general partnerships, (2) cooperative organizations, (3) testing or certification services, and (4) single trademark licenses. While finding nothing objectionable about the exclusion policies expressed in the 1979 Statement of Basis and Purpose published with the Original Rule, the FTC thought that after nearly forty years of regulation, the public understood the contours of the federal franchise definition well enough that they no longer needed exclusions to serve as guardrails for coverage. By removing the exclusions, the FTC made it clear that it was not expanding the scope of the “franchise” definition nor creating new exemptions; it was merely streamlining regulation.

In selecting the eight exemptions, the FTC did not seem particularly motivated to align federal exemptions with exemptions under state franchise sales laws,
nor did it seem particularly influenced by existing state exemptions. Several years later, the North American Securities Administrators Association (NASAA) on September 9, 2012, adopted a proposed set of model exemptions from state franchise registration (and, in some cases, disclosure), and it likewise did not seem particularly motivated to align model exemptions for state franchise laws with the Amended Rule’s existing system of exemptions. As explained in the Introduction to this book, the lack of federal preemption of state franchise laws and the hodgepodge misalignment of federal and state franchise law exemptions make it difficult for a franchisor today to design a franchise program that meets exemption criteria in all fifty states. However, under appropriate circumstances, utilizing an exemption can result in time and expense savings.

Unlike some state franchise sales laws where qualifying for an exemption might relieve a franchisor from registration duties or, in some situations, from both registration and pre-sale disclosure duties, but not from the statute’s fraud provisions, a franchise that qualifies for an exemption from the federal Amended Rule is exempt for all purposes.

The following discussion addresses each of the eight federal exemptions in detail.

II. SPECIFIC FEDERAL EXEMPTIONS

A. Minimum Payment Exemption [Sec. 436.8(a)(1)]

Section 436.8(a)(1) retains the Original Rule’s minimum payment exemption for franchise sales when total required payments, or commitments to make a required

8. See 72 Fed. Reg. at 15,520 n.772 (noting that franchisors exempt from disclosure under the Amended Rule may still need to comply with state franchise laws).


10. See Exemption-Based Franchising, supra note [3], at 191. (“The primary advantage of exemption-based franchising is the cost savings, in both time and dollars.”) However, the authors note that even when federal and state exemptions exist in all of the jurisdictions where a franchisor wants to expand, there are countervailing considerations for why a franchisor exempt from both state registration and federal and state disclosure requirements might still want to prepare a franchise disclosure document (FDD).

11. For example, a franchisor that qualifies for an exemption from the California Franchise Investment Law is only exempt from Part 2, the section that imposes registration and disclosure duties, but not from Part 3, which forbids fraudulent and prohibited practices in connection with franchise sales. See CAL. CORP. CODE §§ 31100–31109.1 (Deering 2014) The Amended FTC Rule does not provide a private right of action, but its violation may support a state “baby” FTC Act claim as an unfair or deceptive trade practice or common law claims for fraud. See, e.g., KC Leisure, Inc. v. Haber, 972 So. 2d 1069 (Fla. Dist. Ct. App. 2008).
payment, to the franchisor or an affiliate of the franchisor during the relevant period are below a minimum amount. The relevant period spans from before the franchisee signs the franchise agreement to six months after the franchisee begins doing business with the public. The minimum threshold in the Original Rule was $500. However, the FTC raised the minimum on July 1, 2012, to $540 and then again on July 1, 2016, to $570, pursuant to directions in the Amended Rule requiring the FTC to “adjust the size of the monetary thresholds every fourth year based upon the Consumer Price Index for all urban consumers published by the Department of Labor.”

The rationale for the exemption is regulatory economy. The FTC sees no reason to regulate franchise transactions where the franchisee’s personal financial risk is not considered significant. The Original Rule was based on an extensive public record that convinced federal regulators to set the minimum threshold at $500. Decades later, federal regulators decided to leave the threshold amount alone despite pressure to raise the limit to as high as $5,000. By moving lower-cost business opportunity investments out of the Amended Rule and into a separate business opportunity regulation, the FTC determined that there was no need to raise the minimum threshold; it determined that even raising the minimum to $5,000 would not significantly reduce the number of franchisors that had to comply with the Amended Rule. At the same time, while benefiting only a small fraction of franchisors, the FTC decided not to eliminate the exemption, concluding that “the exemption and its $500 threshold continue to serve a useful purpose.”

The phrase found in the Amended Rule, “or commitments to make a required payment,” was not in the Original Rule. Its addition in 2007 appears to correct an

12. In the Original Rule, the exemption was found at 16 C.F.R. 436.2(a)(3)(iii).
14. 1979 SBP: “The record supports the proposition that the rule should focus upon those franchisees who have made a personally significant monetary investment and who cannot extricate themselves from the unsatisfactory relationship without suffering a financial setback.” 48 Fed. Reg. at 59,704.
15. The FTC noted in the 2007 SBP: “During this Rule amendment proceeding, no commenter recommended eliminating or reducing the $500 minimum payment threshold.” 72 Fed. Reg. at 15,521.
16. During the Amended Rule’s rulemaking process, the FTC researched prevailing initial franchise fees in evaluating whether the $500 threshold should be increased with FTC staff members reviewing information supplied by over 1,000 different franchises profiled in the 2001 edition of Bond’s Franchise Guide. All but forty-one of the franchise systems surveyed reported charging initial franchise fees of $5,000 or more (approximately 96% of reporting systems). Of the forty-one systems charging $5,000 or less, twenty-two reported charging initial franchise fees of $1,000 or less. Based on this evidence, the 2007 SBP concluded that even a $5,000 minimum payment threshold “would not reduce significantly the number of franchisors that must comply with the Rule’s disclosure obligations.” 72 Fed. Reg. at 15,521.
17. Id. at 15,520–15,521.
Exemptions Under the FTC Franchise Rule

ambiguity in the Original Rule over whether a commitment to pay a franchisor $500 or more during the relevant time period—from before buying the franchise through the end of the first six months of operation—would in itself deny the exemption even if the franchisee did not actually pay more than the minimum amount during the relevant time period. The 1979 SBP itself was unclear on this point. The ambiguity created confusion about two common situations:

- Was an arrangement exempt if a franchisor, at the time the franchise agreement was signed, could not predict the exact amount of a franchisee’s payments during the relevant period, which is the case when the only fees payable during the relevant period are measured by the franchisee’s actual sales, something a franchisor cannot control?
- Was an arrangement exempt if a franchisee entered into a contract, lease, or promissory note when it bought a franchise and committed to pay $500 or more starting sometime after the end of six months?

FTC interpretive opinions issued after the Original Rule became effective clarify that the franchisor carried the burden of proof for any exemption. A franchisor that wants to claim that a franchise sale qualifies for the minimum payment exemption bears responsibility for assessing, at the time of the sale, the likelihood that the franchisee’s payments during the relevant time period will exceed the minimum based on various considerations. Specifically, in situations where a franchisee signs a non-negotiable promissory note when it buys a franchise, the availability of the exemption hinges on whether the franchisor

18. See, e.g., FTC Informal Staff Advisory Op 96-5, CCH Business Franchise Guide ¶ 6480 (Nov. 15, 1996) (“As a matter of policy, Commission staff will determine Rule coverage by the reasonable expectations of the parties at the time they enter their franchise agreement.”). See also FTC Informal Staff Advisory Op. 93-12, CCH Business Franchise Guide, ¶ 6456 at 9636–37 (Jan. 28, 1994) [discussing when a franchisee’s duty to make speculative future payments (for example, royalty payments that depend on the franchisee’s future level of revenue, constitute minimum required payments even though the exact amount of the payment is not specified and is unknown to the franchisor when the franchisee makes the commitment to pay)]; FTC Informal Staff Advisory Op. 97-9, CCH Business Franchise Guide ¶ 6489 (Dec. 18, 1997) (discussing speculative future payments under an Option Agreement and noting that the franchisor carries the burden of proof that it qualifies for an exemption and therefore must gauge the likelihood that the franchisee will, or will not, pay above the minimum threshold during the relevant time period by considering (i) typical revenues for the industry; (ii) likely revenues based on the sales price of the goods or service generating future royalties, the likely demand for such goods or services, and the royalty rate; (iii) the financial history of the franchisor and other franchisees; (iv) any representations made by the franchisor to the prospective franchisee about potential income. The FTC cautioned franchisors that it construed exemptions narrowly and “advised franchisors to err on the side of caution and provide prospective franchisees with disclosure documents, unless they can establish beforehand that they will qualify for the minimum required payment exemption.”).
may accelerate payments to make them due within the relevant time period.\textsuperscript{19} When the FTC overhauled the Franchise Rule, it cleared up the confusion by adding the phrase “or commitments to make a required payment” and the words “that are made.”\textsuperscript{20}

The exemption can be useful to franchisors that are willing to defer most of their fees for a modest period of time to avoid the expenses and burdens of preparing a FDD. The exemption might prove particularly attractive to a conversion franchise program, one that recruits existing small businesses to reflag their operations under the franchise brand, since a conversion franchisee may require little to no “ramp-up” time to begin operating after buying the franchise so that the actual deferral period may, in fact, be as short as six months. The exemption may be less attractive to franchise programs that involve an elaborate build-out process, such as a restaurant, where the time between signing a franchise agreement and the opening date might be six months or longer, to which six months of operating history must be added before the franchisor may collect more than $500.

Of course, what counts as a required payment is broadly defined. It includes more than an initial franchise fee or royalty payment; it also includes equipment purchases, licensing fees for specially configured software, and purchases of proprietary materials or ingredients—all of which may be essential to operations from day one. It includes payments to a franchisor or its affiliate even if they do not profit from the sale or markup the price of goods. It includes training fees payable anytime before the end of the first six months of operations and lease payments even to a third-party landlord when the franchisee must rent the franchise premises from the franchisor or an affiliate as a condition of the franchise. Each of these payments may be something a franchisor with limited cash flow cannot wait to receive, especially when it incurs costs to deliver pre-opening goods and services. Consequently, the minimum payment exemption may offer

\footnotesize{\textsuperscript{19} See, e.g., FTC Informal Staff Advisory Opinion 98-3, CCH Business Franchise Guide ¶ 6492 (May 4, 1998) (“a secured, non-negotiable promissory note (without an acceleration clause) probably qualifies for the Rule’s minimum payment exemption”); FTC Informal Staff Advisory Op 96-5, CCH Business Franchise Guide ¶ 6480 (Nov. 15, 1996) (franchisor qualified for minimum payment exemption when it required franchisee to sign a non-negotiable promissory note at the time of the franchise sale that required payments of less than $500 during the first six months and expressly stated that its maturity date would not be “sooner than six months after the date the licensee is obligated to commence operating the licensed business.”)

\textsuperscript{20} In the 2007 SBP, the FTC commented that it rejected the request to narrow the minimum payment exemption by counting toward the minimum threshold both commitments to pay made during the first six months regardless of when made and commitments arising by contract or by practical necessity. See 72 Fed. Reg. at 15,521 and n.785.}
only limited opportunities for a trademark licensor to structure a licensing program to avoid regulation as a franchise.21

Even when available, the biggest shortcoming of the minimum payment exemption is that only one registration state, South Dakota, has a comparable exemption.22 Franchise registration states that exempt franchise sales when only a nominal fee is paid consider all required payments during the course of a year.23 Therefore, a franchisor that wants to rely on the federal minimum payment exemption to avoid having to prepare an FDD must plot its expansion strategy carefully and steer clear of all but one franchise registration state. This stifles any franchisor with plans to expand into more populous states such as California, New York, and Florida.

One useful application of the minimum payment exemption, which also works in franchise registration states, is for trademark licensors who are willing to limit the payments under their trademark license agreements to the bona fide wholesale price of goods, provided they are also willing to limit inventory purchase requirements to reasonable amounts of the goods. Such payments are not considered required payments under the Amended Rule or state franchise laws.24

21. What counts as a required vs. optional payment is a question of fact that depends on practical necessity. Merely calling a payment optional is not controlling. Therefore, when a payment to a franchisor or its affiliate is for goods or services that are essential to operations or will improve the licensee’s chances for successful operations and the goods or services are not readily available from an unaffiliated third party as a reliable supply source, the payments to the franchisor or its affiliate will be treated as a franchise fee and counted towards the minimum payment threshold even though the parties’ agreement may describe the payment as optional. See FTC Informal Staff Advisory Opinion in re: A.O. Smith Harvestore Products, Inc., CCH Business Franchise Guide ¶ 6431 (August 11, 1982) (“[p]ayments will be considered ‘optional,’ and not ‘required,’ when the dealer’s option is genuine and realistic in the context of the industry and community in which he chooses to conduct business. This will be determined in part by the franchisor’s financial incentive to condition the establishment of the relationship on payment for ‘optional’ items, any indicia of overt or covert franchisor pressure on the franchisee to make such payments, and the ability of the dealer to obtain an equivalent and competitive source of supply as a practical matter. It is not sufficient that a dealer could buy from others or that some have in fact done so. The choice for each dealer must be real, legitimate, and practical.”). This FTC opinion goes on to state that when a dealer makes a genuinely optional payment to a third party that, in turn, remits a portion of the payment to the franchisor or its affiliate, the amount remitted is considered a required payment.


23. See, e.g., California ($500), CAL. CODE REGS. tit. 10, § 310.011 (2015); Illinois ($500), 815 ILL. COMP. STAT. 705/3(1)(c) (2015); Maryland ($100), MD. CODE REGS. 02.02.08.10 (C) (2015); Michigan ($500), MICH. COMP. LAWS § 445.1506(6)(1)(c) (2015); Washington ($500), WASH. REV. CODE § 19.100.030(4)(b)(iii) (2015); Wisconsin ($1,000) WIS. ADMIN. CODE DFI-Sec 32.05(1)(b) (2015).

B. FRACTIONAL FRANCHISE [SEC. 436.8(A)(2)]

The Amended Rule retains the Original Rule’s exemption for “fractional franchises,” which covers the situation where a prospective franchisee with at least two years of experience in the same type of business as the franchisor enters into an arrangement with the franchisor to add a new product or service line associated with the franchisor’s brand that will account for less than 20% of the prospective franchisee’s expected gross sales in the first year of operation. Common fractional franchises include hotels, universities, and airports that operate branded food service operations under a license from the brand owner.25

The exemption’s rationale is that when the two narrowing features of the exemption are met—prior experience and the 20% limit—regulation of the franchise sale is not necessary. Per the FTC, a prospective franchisee with at least two years of experience in the same line of business is, or should be, familiar with the costs, profits, and potential problems of distributing similar goods and services.

Either the prospective franchisee or any one of the current directors or officers of the franchisee or its parent or another affiliate may supply the minimum experience, which extends the federal exemption to situations where, for example, a newly formed entity operates the franchise line. Indeed, a current officer or director may supply the experience based on prior employment where there is no relationship between the former employer and the franchisee. Unlike some state fractional franchise exemptions where the prior experience must be satisfied within a certain time period before purchasing the fractional franchise, the federal fractional franchise exemption sets no time limit for how far back a franchisee may reach to demonstrate the requisite two years’ experience.26

The experience requirement, summarized by the phrase “more than two years of experience in the same type of business,” covers situations where prior experience is transferable to the new franchise line. The concept of transferability is not rigid: the fractional franchise exemption applies where the franchisee or an officer or a director has sold the same type of goods or services as the new franchise line or has been in a business that would ordinarily be expected to do so. Furthermore, it is not necessary for a fractional franchisee to have sold the

25. See Earsa R. Jackson and Karen B. Satterlee, Navigating The Exemption/Exclusion Maze Under The Amended FTC Rule and State Laws, ABA 31st Annual Forum on Franchising (2008) W-11, 3–4. The paper, which was published right after the Amended Rule became effective, reported that Starbucks had, up to that point, relied exclusively on the fractional franchise exemption in expanding throughout the United States.

26. The Amended Rule is silent on how far back the experience may be relative to when the new franchise line is added, but the Interpretive Guides to the Original Rule explicitly state that the two-year experience may be at any time in the past. See Leonard D. Vines, Beata Krakus, Karen Satterlee, Fractional Franchise Exemption: Friend or Foe?, 30 Franchise L.J. 72, 76 (2010) (“Fractional Franchise Exemption”).
Exemptions Under the FTC Franchise Rule

identical goods or services or been in the identical business as the new franchise line: same type means "similar."

Nevertheless, a franchisor that wants to claim the exemption must make a judgment call regarding whether a putative fractional franchisee possesses the requisite experience, particularly since FTC Informal Advisory Opinions show that the answer may not be obvious. For example, in one opinion, the FTC found a fractional franchise arrangement where a hospital that already operated a rehabilitation center entered into a license to offer specialized rehabilitative services for back problems using patented equipment, but the following year, the FTC opined that a hospital could not qualify as a fractional franchisee when it entered into a licensing arrangement to add travel immunization services since the hospital, despite obvious proficiency giving injections, lacked the requisite two years of experience in providing travel-related services.

The 1979 SBP sums up the litmus test this way as to whether particular experience is sufficiently exchangeable that it will benefit the franchise in selling the extra franchise line:

If, for example, the prospective franchisee has operated a hardware store for the past 10 years, but has never sold lawn care equipment before, he will still be in the business represented by a franchise to sell lawn care equipment because hardware stores commonly carry such goods and the franchisee can be expected to have some familiarity with comparable goods. In contrast, a gasoline station dealer would not be in the business represented by a car rental franchise because the experience of selling gasoline would not give the franchisee any familiarity with the problems of renting cars.

However, commentators caution that evaluation of “same business” is subjective, which makes it challenging to rely on the exemption with peace of mind.

27. See FTC Informal Staff Advisory Op. 97-1, CCH Business Franchise Guide ¶ 6481 (Nov. 5, 1996); FTC Informal Staff Advisory Op. 97-8, CCH Business Franchise Guide ¶ 6487 (Aug. 18, 1997) (noting that the Original Rule had no investor exemption and finding “no indication . . . that the Hospitals have been in the business of offering travel information or products or that they would be expected to understand from their past experience the risks in entering into such a business”). See generally Fractional Franchise Exemption, supra note [25], at 85. The Amended Rule incorporates the public policy reasons for the fractional franchise exemption embraced in the Original Rule. Therefore, the Informal Advisory Opinions under the Original Rule are still relevant today.


29. 43 Fed. Reg. at 59707 n.80

30. See Fractional Franchise Exemption, supra note [25] at 75 (“it may be very hard to draw the line between what is the same business and what is not”).
The second condition of the federal fractional franchise exemption, the 20% cap on gross sales from the extra franchise line, limits the exemption to arrangements where the franchisee is not overly dependent on the franchise line for its success and unlikely to fail in business should the franchise line fail. The 20% limit considers the incremental sales gain over existing sales in the franchisee’s entire similar business line, so where a franchisee owns several hardware stores and adds the new franchise product line just at one store, the 20% considers the increase in sales attributed to the new product line against the franchisee’s aggregate total sales volume for all products sold at all of the franchisee’s hardware stores.

The Amended Rule further refined the Original Rule’s “fractional franchise” definition by (i) the requiring the franchisor to have a “reasonable basis” for estimating the 20% or less sales threshold and (ii) confining the sales estimate to first-year sales only. While the franchisor claiming the exemption has the burden of proving that the exemption conditions are met, the FTC will consider whether the franchisee also anticipates deriving 80% or more of its income from sales independent of the added franchise line. Consequently, a sound business practice for franchisors wanting to rely on the federal fractional franchise exemption is to ask the franchisee to prepare its own projections and market analysis of the additional incremental sales that it anticipates during the first year from the added franchise product or service line, recognizing that the franchisee’s prior experience and industry knowledge gives it the capacity to make reliable projections. At the same time, a franchisor should not naively accept a franchisee’s bald allegations even when the franchisee is experienced: the franchisor should independently evaluate the reasonableness of the franchisee’s projections and compare them against its own historical data, industry-wide statistics, and market analysis.

31. 43 Fed. Reg. at 59707 n.84: “The Commission believes that 20 percent is a reasonable cut off point because investments beyond that amount are of sufficient import to adversely affect the entire business of the franchise as well as being a significant loss in and of themselves.”


35. FTC Informal Staff Advisory Op. 97-1, CCH Business Franchise Guide ¶ 6481 (Nov. 5, 1996). Commentators note that a franchisee’s written statement about projected franchise sales “even without sufficient substantiation may be helpful when litigating fraud claims.” See Fractional Franchise Exemption, supra note [25], at 78. The FTC has said that a franchisor need not rely on its own historical performance in making its own projections. For example, in one advisory opinion, the FTC said that a franchisor that lacks past sales history could rely on the performance of a similar franchise program in the European market. FTC Informal Staff Advisory Op. 97-1, CCH Business Franchise Guide ¶ 6481 (Nov. 5, 1996). The franchisor need not involve an accountant in projecting sales from the added product or service line. FTC Informal Staff Advisory Op. 98-6, CCH Business Franchise Guide ¶ 6495 (Aug. 12, 1998). See also Fractional Franchise Exemption, supra note [25], at 78–81.
Exemptions Under the FTC Franchise Rule

If a franchisor’s projections are reasonable when a fractional franchise relationship is formed, the relationship is not stripped of its exempt status retroactively if actual sales from the added product or service line turn out to exceed the 20% threshold limit in the first year. As long as the qualification process demonstrates the franchisor’s due diligence and the assumptions underlying its original estimate, the exemption is not lost because the franchisor in good faith underestimates first-year sales.\(^3\)\(^6\) The fractional franchise exemption rests on the franchisor’s good-faith estimate and does not depend on absolute certainty in predicting first-year results from the added product or service line.

At a minimum, a franchisor should not share its sales projections for the added product or service line with the prospective fractional franchisee or comment on the prospective franchisee’s own projections. Otherwise, the franchisor may risk making an unintended financial performance representation.

When the 20% limit is combined with the requisite prior experience, the FTC dispenses with pre-sale disclosure, believing that the prospective fractional franchisee has sufficient business acumen to evaluate the franchisee’s promotional claims and will not suffer significant financial risks if those claims turn out to be false.\(^3\)\(^7\) But a franchisor should not claim the federal fractional franchise exemption if there is any doubt about the qualification conditions. A franchisor should review qualification conditions with experienced franchise counsel before closing the franchise sale. Furthermore, even if the transaction is exempt as a fractional franchise, inaccurate financial performance representations, if shared, could support a state “baby” FTC Act claim as an unfair or deceptive trade practice or as common law fraud causes of action.\(^3\)\(^8\)

As explained later in this book, not all registration states have adopted a fractional franchise exemption, and among the states that have, there are many variations. Some states measure the 20% cap differently, or annually, or establish a time limit for how far back the prior experience may reach relative to the franchise sale. But the fractional franchise exemption, unlike other types of exemptions such as the one for petroleum marketers, is franchisee-centric, meaning that even with the same jurisdiction, it will not automatically blanket all franchise sales, but instead is candidate-specific. It is possible, however, for a franchisor to structure a franchise program and confine franchise sales to qualify for a fractional franchise exemption in all states where one exists, as Starbucks claims that it accomplishes successfully.

\(^3\)\(^6\) FTC Informal Staff Advisory Op., \textit{Real Amer. Real Estate Corp.}, CCH Business Franchise Guide ¶ 6428 (Apr. 9, 1982).
\(^3\)\(^8\) \textit{Fractional Franchise Exemption}, supra note [25], at 81.
C. LEASED DEPARTMENTS [SEC. 436.8(A)(3)]

Paragraph (a)(3) exempts franchise arrangements commonly referred to as “leased departments” where the only payment by the independent retailer-tenant that occupies space within a larger retailer-landlord’s premises is rent. The exemption is lost if the retailer-tenant must directly or indirectly purchase goods or services from the retailer-landlord or from suppliers required or approved by the retailer-landlord.\(^{39}\)

Strictly as a matter of custom, leased department arrangements often occur with certain types of merchandise (for example, footwear, optometry, cosmetics, and jewelry). The optical department at Costco is an example of a leased department. Macy’s hosts a number of independently owned specialty shops that operate as leased departments in Macy’s department stores and on macys.com.\(^{40}\)

Technically, leased department arrangements meet the three-prong franchise definition: by renting space in a larger retailer’s premises, the retailer-tenant associates its business with the host retailer’s trademark; rent qualifies as a franchise fee; and the substantial assistance/control element exists because “frequently, the retailer-grantor sets standards for the appearance of the operation and quality standards of the goods, and generally permits the retailer-lessee to be associated with the retailer’s operation.”\(^{41}\)

Leased departments and fractional franchises share similar exemption rationales: indeed, the former has been described as a fractional franchise without the 20% cap on gross sales.\(^{42}\) The retailer-tenant is an independent business owner experienced in selling the particular merchandise for which it leases space, does not rely on the larger retailer to supply the merchandise, and can independently assess the value of the location without depending on the retailer-landlord’s representations. The record supporting the exemption in the Original Rule showed no abuses arising from leased department arrangements, and no comments of any nature were received for or against continuing the exemption during the Amended Rule hearings.\(^{43}\) Indeed, the FTC has never been asked to

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39. See FTC Interpretative Guides to the Original Rule, 44 Fed. Reg. 49966, 49968 (Aug. 21, 1979). The limited guidance regarding the exemption states that the large retailer may not profit from the leasing arrangement other than by receiving rent. Obviously, a leasing arrangement has mutually synergistic benefits for both host and tenant retailers as each presumably derives some amount of additional revenue from consumers who initially may enter a “big box” multi-department store for one purpose and end up making other purchases.
41. 43 Fed. Reg. at 59,707.
42. Exemption-Based Franchising, supra note [25], at 193.
43. 43 Fed. Reg. at 59,708 n.91 (In adopting the exemption initially, the FTC concluded: “The record thus does not support the view that the leased department arrangements share the similarities with franchising that have led to the types of abuses documented by the record.”)
issue an Interpretative Advisory Opinion regarding a leased department arrangement, so the exemption continues without controversy and is relied on by many large retailers today.\(^4^4\)

**D. ORAL CONTRACTS [SEC. 436.8(A)(7)]**

The Amended Rule continues the exemption for purely oral relationships when there is no written evidence memorializing a material term of the franchise relationship or agreement, even if unsigned.\(^4^5\) The exemption is exceedingly narrow and, quite frankly, impractical and undependable.\(^4^6\) The FTC’s motivation for adding the exemption to the Original Rule was matter-of-fact: to avoid enforcement difficulties. The FTC rationalized that purely oral arrangements “are usually informal and require only nominal investments,” which, from a regulatory perspective, made it more costly to prove an unlawful franchise sale than the regulatory benefits gained from law enforcement.\(^4^7\)

The 2007 Franchise Rule Compliance Guide (the “Compliance Guide”) makes it clear that the exemption is lost if there is any type of written document that describes any material term or aspect of the franchise relationship.\(^4^8\) To illustrate the narrowness of the exemption, the FTC has said that written evidence sufficient to invalidate the exemption may include unsigned handwritten notes taken by a prospective franchisee during a sales presentation, a fact sheet or other promotional materials describing the franchise, a purchase invoice, sales receipts, price lists, canceled checks, or e-mail or other written communications between

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\(^4^4\). During the Original Rule’s rulemaking process, one commenter objected that host retailers typically dictate lease terms on a take-it-or-leave-it basis permitting cancellation of the lease at will, but the commenter admitted that it had not experienced an unprovoked cancellation. See 43 Fed. Reg. at 59,708 n.90, referencing comments by Petcoa Industries, Inc., at R. III, 1765. Sears and two major retailer lobbying groups, the National Retail Merchants Association and the American Retail Federation, filed the only public comments regarding the proposed leased department exemption during the Original Rule’s rulemaking process.


\(^4^6\). FTC Informal Staff Advisory Op., Contemporary Times, CCH Business Franchise Guide ¶ 6421 (July 18, 1980) (“the exemption for oral agreements will be narrowly construed because it is premised on a very limited and pragmatic policy judgment . . . anticipated compliance and enforcement costs, in the absence of any written evidence of any material term of the agreement, would be disproportionate to the potential benefits resulting from coverage.”).

\(^4^7\). 43 Fed. Reg. at 59,708. The Original Rule’s public record does not mention a single comment filed about the FTC’s proposal not to regulate completely oral relationships despite the fact that oral promises are a well-known hotbed for fraud. None of the registration states have an equivalent exemption; all regulate written or oral franchises. The federal exemption is so narrowly framed that, in fairness, it is difficult to imagine many commercial arrangements qualifying for it indefinitely.

franchise parties referring to one or more material terms of their relationship.\textsuperscript{49} In many respects, the exemption functions as a relaxed statute of frauds.\textsuperscript{50}

Even if an arrangement remains purely oral for some time period, the exemption is lost if written evidence is created at a later date memorializing the existence or a single material term of the parties’ franchise arrangement. The FTC has declined to issue opinions concluding in advance that oral agreements are exempt from franchise rule coverage since it cannot rule out the possibility of a future writing.\textsuperscript{51} Franchisors are advised not to rely on the federal exemption for purely oral agreements since a writing corroborating a material term can readily be created without notice even by a non-party, such as a franchisor’s or franchisee’s advisor or employee, and thereby invalidate the exemption.

\section*{E. Petroleum Marketers and Resellers Exemption \textsuperscript{[Sec. 436.8(a)(4)]}\textsuperscript{52}}

The FTC Rule expressly exempts petroleum marketers and resellers protected by the Petroleum Marketing Practices Act (“PMPA”).\textsuperscript{53} The Commission concluded that those protected by the PMPA did not need the largely duplicative protections of the FTC Rule.\textsuperscript{54} The Compliance Guide notes that the PMPA exemption is intended to be read broadly. Although gasoline stations are the most common types of business to which this exemption applies, it also covers other services and products—such as a repair center, car wash, or convenience store—sold to a prospective franchisee under the same unified franchise agreement as the gasoline station itself.

According to the Compliance Guide, however, “the offer or sale of a convenience store or other franchise to an existing gasoline station franchisee under a separate franchise agreement is not exempt, and is, in fact, no different from

\begin{itemize}
  \item \textsuperscript{49} FTC Informal Staff Advisory Op., Contemporary Times, \textit{supra} note [45].
  \item \textsuperscript{50} The Uniform Commercial Code’s statute of frauds rule applies to the sale of goods for more than $500 where no writing is signed by a party. The Amended Rule’s exemption for purely oral arrangements does not require a signed writing and does not set a time limit for when the future writing must be created.
  \item \textsuperscript{51} FTC Informal Staff Advisory Op., \textit{Contemporary Times}, \textit{supra} note [45] (“we do not expect to be able to issue opinions concluding in advance that oral agreements will be exempt from franchise rule coverage”).
  \item \textsuperscript{52} The remaining portions of this section are adapted from \textsc{Leonard D. Vines \& Jan S. Gilbert}, \textit{The FTC Franchise Rule} ch. 2 (Susan A. Grueneberg \& Ann Hurwitz eds., 2nd ed. 2012).
\end{itemize}
Exemptions Under the FTC Franchise Rule

the ordinary sale of a franchise to an existing franchisee." As a practical matter, the Commission believed that it may be impossible to divide a single franchise agreement for gasoline and other services into its component parts for disclosure purposes, and such an approach would be inconsistent with the PMPA. Nevertheless, the Commission thought that the protections of the FTC Rule were needed in the case of a separate or subsequent sale of a franchise to a gasoline station owner, and hence those sales are not covered by the exemption.

F. Sophisticated Investor Exemptions

Under the FTC Rule, there are three types of exemptions for sophisticated investors:

1. The large investment exemption, which is based on the size of the investment;
2. The large franchise investment, which is based on the net worth of the investor; and
3. The “insider exemption,” which is based on the franchisee’s involvement with the franchisor

Some of the registration states do not recognize the foregoing FTC exemptions; however, several states have their own exemptions based on (1) the experience and financial strength of the franchisor; and (2) the size, net worth, or sophistication of the franchisee. Some states may also offer discretionary exemptions based on the sophistication of the parties. In any event, most state exemptions apply only to registration requirements so that the disclosure requirement remains. As is always the case, when utilizing federal and state exemptions, it is important to review carefully the specific statutory language of the exemption available in each applicable jurisdiction because state exemptions are not consistent and even exemptions with similar names may be different from each other.

These state exemptions go by different names, such as the “experienced franchisor,” the “seasoned franchisor,” the “large franchisor,” and the “high net worth franchisor.” Typically, the franchisor or its parent must satisfy certain minimum statutory requirements for net worth and experience based on the number of years or on the number of franchised locations. In most states, the exemption must be renewed every year, and circumstances may change and result in the loss of an exemption at the federal and state level.

1. LARGE INVESTMENT EXEMPTION [SEC. 436.8(A)(5)(I)]

The large investment exemption applies where the prospective franchisee (or at least one individual where the franchisee is an investor group) makes an “initial investment” totaling at least $1,143,100, minus franchisor financing and the cost of unimproved land. However, the cost of buildings, fixtures, equipment, and other improvements are included as part of the initial investment.56 The minimum threshold in the Original Rule was $1,000,000. However, the FTC raised the minimum on July 1, 2012, to $1,084,900 and again on July 1, 2016, to $1,143,000, pursuant to directions in the Amended Rule requiring the FTC to adjust the monetary thresholds every four years based on the Consumer Price Index.57 The initial investment exemption is based on the rationale that a prospective investor able to invest the threshold amount is likely to be sophisticated and able to make an investment decision without the need for federal government intervention. The Compliance Guide clarifies that “a franchisee’s ‘initial investment’ is limited to the type of expenses that would ordinarily appear in an Item 7 disclosure—expenses paid through the opening of the outlet and any additional expenses paid through the three-month initial period thereafter.”58 Future obligations to pay rent, royalties, or advertising fund contributions are not counted when determining the “initial investment.”59

Further, the exemption focuses on the level of the “initial investment,” not on the number of outlets or the type of outlets being sold. Accordingly, the exemption will apply where the total projected initial investment is reached, whether for a single unit or multiple units.60 The 2007 SBP provides authority for the franchisor to aggregate the initial investment of all units in a multi-unit commitment like an area development agreement and reads in part: “The term ‘initial investment,’ however, need not be limited to a single unit. . . . ‘A multi-unit franchisee investing the threshold amount (or more) in a number of units is just as sophisticated as another franchisee investing a like amount in a single unit’ (quoting from a comment filed during the rulemaking process).” As long as a franchisee signs the acknowledgement that is required for a franchisor to claim this exemption, the 2007 SBP implies at least that the exemption is not lost if a franchisee that makes a multi-unit commitment never in fact invests more than the minimum threshold and opts instead to default under its multi-unit commitment, forfeit any development fees, and not invest above the minimum threshold. The 2007 SBP does not indicate if the FTC considered this particular issue or if any of the commentators

56. Compliance Guide, n.3.
59. Id.
60. The Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. 61, 15526 (March 30, 2007), Business Franchise Guide (CCH) ¶ 6050.
brought the issue to the FTC’s attention. At the same time, the large investment exemption may apply to some, but not all, of a franchisor’s franchise sales. For example, a fast food restaurant franchisor may sell stand-alone, full-facility restaurant franchises for an initial cost of $1,143,100, while at the same time selling kiosks for a much reduced price, such as $100,000. Under those circumstances, only the sale of the stand-alone restaurants would qualify for the exemption.

Conversion franchises and transfers of franchised outlets may qualify for the large investment exemption. In a conversion franchise, a business owner has already invested in his or her existing business and now seeks to associate with a particular franchisor’s mark by entering into a franchise agreement with that franchisor. When considering a conversion franchisee’s “initial investment” in a franchise, the conversion franchisee’s previous investment in the outlet (as opposed to the current value of the outlet) may be considered. This is true even though the conversion franchisee’s initial investment was not paid to the franchisor making the current offer.

In a transfer, a prospective franchisee buys an existing franchise directly from an existing franchisee, but then may enter into a new franchise agreement with the franchisor. The fact that a transferee will assume an existing contract or may renegotiate an existing contract with the franchisor ordinarily has no bearing on his or her level of sophistication as an investor. As long as he or she satisfies the monetary threshold, the large investment exemption is available. As in the case of the conversion franchisee, the prior investment to a party other than the franchisor—here, the transferring franchisee—does not preclude application of the large investment exemption.

At least one individual in an investor group must contribute at the $1,143,100 threshold. The same analysis applies in the case of individual owners of an entity. The response to the FTC Frequently Asked Questions,61 FAQ 3 notes that a small group of individual investors who aggregate small investments will not qualify as sophisticated investors. The Compliance Guide considers a husband and wife as a single individual, since their assets are typically commingled. Section 436.8(b) of the Rule notes that the $1,143,100 threshold may be adjusted for inflation every four years. The large investment exemption does not address how a qualifying individual may organize its business; however, according to FAQ 3, “(n)othing in the FTC Rule would preclude a qualifying individual contributing $[1,143,100]—and thus exempt from the FTC Rule—from forming a partnership, corporation, or joining with a corporation or other entity, to operate the franchised outlet after signing the franchise agreement.”

The prospective franchisee must sign an acknowledgment that the franchise sale is exempt from the FTC Rule, because the prospect will be making an initial investment of at least $1,143,100. Although the FTC Rule does not specify the exact format of the acknowledgment, the Compliance Guide states that it must contain the following prescribed statement:

The franchise sale is for more than $1,143,100—excluding the cost of unimproved land and any financing received from the franchisor or an affiliate—and thus is exempt from the Federal Trade Commission’s FTC Rule disclosure requirements, pursuant to 16 C.F.R. §436.8(a)(5)(i).

2. LARGE FRANCHISEE EXEMPTION [SEC. 436.8(a)(5)(ii)]

Sales to large entity franchisees that have been in any business for at least five years and have a net worth of at least $5,715,500 are exempt from coverage under the FTC Rule. The minimum in the Original Rule was $5,000,000. However, the FTC raised the minimum on July 1, 2012, to $5,424,500 and again on July 1, 2016, to $5,715,500, pursuant to directions in the Amended Rule requiring the FTC to adjust the monetary thresholds every four years based on the Consumer Price Index. The Commission was convinced that sales to large entities, such as airports, hospitals, and universities, did not require federal government intervention and is sophisticated enough to negotiate and protect its interests. However, the exemption applies to any entity that meets the two-pronged test of both net worth and prior business experience.

The Compliance Guide states that the prior business experience can be in any business, and there is no requirement that it be in franchising or even in the franchise business in particular. The experience of a subsidiary will satisfy the experience requirement of this exemption. Further, the net worth of an entity can be determined from the entity’s balance sheet or other financial information.

The Compliance Guide has clarified that “franchisors may consider the prior experience and net worth of the prospective franchisee’s affiliates and parents,” and thus, franchisors may aggregate commonly owned franchisee assets in determining the availability of the large entity exemption. An example from the Compliance Guide is a hotel franchisee that establishes a separate entity for a particular transaction. Even if the new entity does not meet the net worth or

62. Id. at 12.
experience requirement, the net worth of its parent can be aggregated with com-
monly owned franchisee assets to satisfy the requirements of the large entity
exemption.

In addition, the Commission noted that an individual may constitute an “entity”
for purposes of the large entity exemption, but “most individuals who have been
in business for at least five years and have generated an individual net worth of
at least $5,715,500 are likely to have created a corporation or other formal orga-
nization through which to conduct business.”

3. INSIDERS EXEMPTION [SEC. 436.8(A)(6)]
The Rule includes an exemption for franchise sales to two categories of “insiders”: (1) officers, directors, general partners, or managers of a franchisor on the one
hand and (2) owners of a franchisor on the other hand. The prerequisites to
qualify for this exemption differ depending on whether the individual franchise
purchaser is an officer, a director, a general partner, or a manager on the one
hand or an owner on the other hand.

1. Officers, Directors, General Partners, and Managers.

To qualify for the exemption, an officer, a director, a general partner, or a man-
ager of the franchisor must (a) seek to purchase at least 50% ownership interest in
the franchise and (b) have at least two years of experience with the franchisor as
an officer, a director, a general partner, or a manager. The prior experience must
be recent—the officer must currently be associated with the franchisor or have
been associated with the franchisor within sixty days of the proposed franchise
sale. The Compliance Guide gives the following examples:

- **Two Years’ Experience of an Officer.** An officer new to the company with only
  fourteen months of experience would not qualify for the exemption. The officer
  must have two years of experience with the company to qualify.
- **Officer’s Experience Within 60 Days of Sale.** An officer with five years of expe-
  rience with the company who leaves the company on January 1, 2007, would
  not qualify for the exemption if she were to seek to purchase a franchise on
  July 1, 2007. The officer’s prior experience must be within 60 days of the
  franchise sale.

64. See Statement of Basis and Purpose n.845.
65. This exemption is modeled after the language in a section of the California experi-
enced franchisee exemption. California Franchise Investment Law, California Corporations
Code, Division 5, Parts 1–6, Section 31106. Washington and Rhode Island have similar
exemptions.
2. Owners.

To qualify for the exemption, an owner must also (a) seek to purchase at least a 50% ownership interest in the franchise and (b) have owned at least a 25% interest in the franchisor for at least two years. The ownership interest must be recent—at least sixty days before the sale of the franchise. The Compliance Guide includes the following examples:\textsuperscript{67}

- \textit{25\% Ownership Interest in Franchisor}. An owner of only a 10\% interest in a company would not qualify for the exemption. The owner must own at least 25\% of the company to qualify.
- \textit{Length of Time of Ownership in Franchisor}. An owner of a 50\% interest in the franchisor would not qualify for the exemption if he owned his interest for only eight months. To qualify, an owner, even if a sole stockholder, must own his interest for at least two years.
- \textit{Ownership Within Sixty Days of Sale}. A sole stockholder of the company would not qualify for the exemption if she sells her shares in the company and then seeks to purchase a franchise eight months after the sale. The ownership interest must be recent—within sixty days of the sale.

The exemption covers not only owners and officers of the franchise system but also those with direct management experience. The Commission thought that the two-year and sixty-day prerequisites noted above are likely to ensure that the prospect is, in fact, a bona fide officer or owner and would prevent a franchisor from skirting disclosure obligations by, for example, putting a prospective franchisee on the board of directors a few days or weeks before the sale and removing him or her shortly thereafter. The Commission recognized that in such circumstances, it reasonably can be assumed that the prospective franchisee already is familiar with the business system and the associated risks and disclosure would serve little purpose.

In addition, the Commission believed that the compliance burden would be unreasonable for a previously non-franchised company that wants to sell a limited number of outlets only to experienced company personnel. The Commission also noted that the exemption is company-specific. Hence, a manager of one company is not deemed sophisticated for all franchise sales. Rather, the exemption would apply only to a manager or other officer seeking to purchase a franchise of that very company.

\textsuperscript{67} Id.
FAQ 26 clarified that this exemption would not apply to a situation in which a company that has not yet publicly offered or sold franchises sells a franchise to a manager with two years’ experience until actual sales and operation of the franchise system have begun, a manager cannot acquire “responsibility for the offer and sale of the franchisor’s franchises,” and there can be no “administrator of the franchised network.” According to the FAQ, to be exempt, the sale of a franchise to the franchisor’s manager cannot be exempt until two years after the franchisor has begun public sales of franchises. On the other hand, the exemption is available to an “owner,” an “officer,” a “director,” or a “general partner” of a company who also meets the two-year requirement, both before and after the franchisor has begun public sales of franchises.68

68. FAQ 26 noted the distinction between its interpretation and the express language of the Statement of Basis and Purpose which indicates that the exemption is also intended for start-ups, noting that the plain language of the Rule provision requires that managers have experience with the company after it has begun franchise operations. This restriction makes sense because an owner, an officer, a director, or a general partner of a start-up may be knowledgeable about franchising and have control over the terms of the contemplated franchise relationship, but a manager without actual experience with the company after it has begun franchising likely would not, and, therefore, would benefit from the disclosures in the Disclosure Statement.