American Bar Association
42nd Annual Forum on Franchising

HOW SHOULD THE FTC RULE BE RESTRUCTURED, IF AT ALL?

Peter Lagarias
Lagarias, Napell & Dillon, LLP
San Rafael, California

and

Jonathan Solish
Bryan Cave Leighton Paisner
Santa Monica, California

October 16–18, 2019
Denver, CO

©2019 American Bar Association
TABLE OF CONTENTS

W-9: HOW SHOULD THE FTC RULE BE RESTRUCTURED, IF AT ALL? ........................................... 1
I. A BRIEF HISTORY OF THE FRANCHISE DISCLOSURE RULE AND STATE DISCLOSURE LAWS ....................................................................................................................... 1
II. THE REQUEST FOR PUBLIC COMMENT ........................................................................ 3
III. AN OVERVIEW OF THE PUBLIC RECORD COMMENTS TO DATE .............................. 3
   A. Comments in Response to Specific FTC Questions ................................................... 3
   B. Is There a Continuing Need for the Rule? Why or Why Not? .................................... 4
       1. Support for the Current Rule—Selected Franchisee Perspective ...................... 4
       2. Support for the Rule—Selected Franchisor Perspective .................................... 5
   C. What Benefits, if Any, Has the Rule Provided to Prospective Franchisees, Including Small Businesses? What Evidence Supports the Asserted Benefits? ................................................................. 5
   D. What Modifications, if Any, Should be Made to the Rule to Increase its Benefits to Prospective Franchisees, Including Small Businesses? ...................... 6
       1. The Effect of Disclosures and Disclaimers—Selected Franchisee Perspective .......... 6
       2. The Effect of Disclosures and Disclaimers—Selected Franchisor Perspective .......... 7
   E. The Proposed Ban of Mandatory Arbitration Clauses .............................................. 8
       1. Selected Franchisee Perspective ........................................................................... 8
       2. Selected Franchisor Perspective ........................................................................ 9
IV. Comments on Required Rule Disclosures Item by Item .............................................. 9
   A. Disclosure of Franchisor Representations to Banks—Selected Franchisee Perspective ................................................................................................................................. 12
B. Disclosure of Franchisor Representations to Banks—Selected Franchisor Perspective

C. Renewal on Then Current Terms—Selected Franchisee Perspective

D. Renewal on Then Current Terms—Selected Franchisor Perspective

E. Disclaimers in Financial Performance Representation Claims—Selected Franchisee Perspective

F. Disclaimers in Financial Performance Representation Claims—Selected Franchisor Perspective

G. Disclosure of Franchisees’ Financial Performance Data—Selected Franchisee Perspective

H. Disclosure in Franchisees’ Financial Performance Data—Selected Franchisor Perspective

I. Overall Items of Disclosure—Selected Franchisee Perspective

J. Overall Items of Disclosure—Selected Franchisor Perspective

V. WHAT MODIFICATIONS, IF ANY, SHOULD BE MADE TO THE RULE TO INCREASE ITS BENEFITS TO FRANCHISORS AND FRANCHISE SELLERS, INCLUDING SMALL BUSINESSES?

VI. WHAT SIGNIFICANT COSTS, IF ANY, INCLUDING COSTS OF COMPLIANCE, HAS THE RULE IMPOSED ON FRANCHISORS AND FRANCHISE SELLERS, INCLUDING SMALL BUSINESSES? WHAT EVIDENCE SUPPORTS THE ASSERTED COSTS?

VII. WHAT MODIFICATIONS, IF ANY, SHOULD BE MADE TO THE RULE TO REDUCE THE COSTS IMPOSED ON FRANCHISORS AND FRANCHISE SELLERS, INCLUDING SMALL BUSINESSES?

VIII. WHAT MODIFICATIONS, IF ANY, SHOULD BE MADE TO THE RULE TO ACCOUNT FOR CHANGES IN RELEVANT TECHNOLOGY OR ECONOMIC
CONDITIONS? WHAT EVIDENCE SUPPORTS THE PROPOSED MODIFICATIONS? ........................................................................................................23

A. Concerns that FDDs are Difficult to Read ..........................................................23
   1. Joint Commentary on the State of Readability and Delivery of Information ........................................................................................................25
   2. Formatting of Disclosures and Technology—Selected Franchisee Perspective ................................................................................................26
   3. Formatting of Disclosures and Technology—Franchisor Perspective ........................................................................................................27

B. Proposal for Federal Preemption .......................................................................28
   1. Federal Preemption—Selected Franchisee Perspective ..........................29
   2. Federal Preemption—Selected Franchisor Perspective ...........................30

C. Proposed Creation of a Private Right of Action ..................................................31
   1. Proposed Federal Private Right of Action—Selected Franchisee Perspective ........................................................................................................31
   2. Proposed Federal Private Right of Action—Selected Franchisor Perspective ................................................................................................31

D. Proposals Regarding Enforcement and that the FTC Extend its Regulation to Franchise Relationship Issues ......................................................32
   1. Proposed Commission Regulation of Franchise Agreement Terms—Selected Franchisee Perspective ..........................................................33
   2. Proposed Commission Regulation of Franchise Agreement Terms—Selected Franchisor Perspective ..................................................................34

E. The “What is a Franchise?” Issue ......................................................................35
   1. Definition of “Franchise”—Selected Franchisee Perspective ..................35
   2. Definition of “Franchise”—Selected Franchisor Perspective ...................35
IX. CONCLUSION AND WHITHER NOW? .................................................................36

A. Rule Review—Selected Franchisee Perspective ........................................37
B. Rule Review—Selected Franchisor Perspective .......................................38
W-9: HOW SHOULD THE FTC RULE BE RESTRUCTURED, IF AT ALL?

This past February and March 2019, the Federal Trade Commission (the “FTC” or “the Commission”) requested public comment on its Trade Regulation Rule entitled “Disclosure Requirements and Prohibitions Concerning Franchising, 16 CFR Part 436 (the “Rule”). The Commission specifically solicited comments from the franchise community “about the efficiency, costs, benefits and regulatory impact of the Rule as part of its systematic review of all current Commission regulations and guides.”¹ This paper discusses the comments that have been submitted and provides further pertinent analysis about them.

I. A BRIEF HISTORY OF THE FRANCHISE DISCLOSURE RULE AND STATE DISCLOSURE LAWS

The seminal Rule became effective on July 21, 1979 following public comment and a series of hearings.² “The primary purpose of the Rule is to provide prospective purchasers of franchises the material information they need in order to weigh the risks and benefits of such an investment by providing disclosure requirements in a uniform format that facilitates comparison shopping.”³ As adopted, “The Rule makes it an unfair or deceptive act or practice for franchisors to fail to give prospective franchisees a Franchise Disclosure Document providing specific information about the franchisor, the franchise business, and the terms of the franchise agreement. The Rule also prohibits related misrepresentations by franchise sellers.”⁴

The initial regulatory review of the Rule commenced in 1995.⁵ After public comment and additional hearings, the Commission determined that the Rule was still needed and issued amendments that became effective in 2008.⁶ The changes in the 2008 amendments included the use of the name Franchise Disclosure Document (“FDD”) instead of the former Uniform Franchise Offering Circular (“UFOC”) and “financial performance representations” instead of the former “earnings claims.” In addition, “[t]he Amended Rule sought, among other changes, to reduce inconsistencies between federal and state pre-sale disclosure requirements and established a set of uniform disclosure requirements in an FDD.”⁷ In its current rulemaking notice, the Commission summarized the Rule as follows:

The Amended Rule requires franchisors to provide prospective franchisees with their FDD at least 14 calendar days before they make any payment or sign a binding agreement in connection with a proposed franchise sale. The FDD provides prospective franchise purchasers with 23 items of information material to their investment decision, including the initial fees and estimated initial

¹ 84 Fed. Reg. 9,051 (March 13, 2019).
⁴ Id.
⁵ 60 Fed.Reg.17,656 (April 7, 1995).
⁷ 84 Fed. Reg. 9,051.
investment required; the litigation and bankruptcy history of the franchisor, its officers, and key executives; the financial performance of existing company-owned and franchised outlets; contact information for current and former franchisees; and financial statements reflecting the ability of the franchisor to provide promised services and support. The FDD also requires disclosure of any restrictions on the sources of goods and services and any required purchases; a franchisee’s contractual obligations in the establishment and operation of the franchise; the terms of any financing offered by the franchisor; the training and assistance provided by the franchisor; the extent to which the franchisee’s outlet is protected from competition by the franchisor and other franchisees; any restrictions on what the franchisee may sell; the circumstances in which the franchise may be prematurely terminated or in which the franchisee’s sale or renewal of the franchise may be refused by the franchisor; how and where any disputes will be resolved; any restrictions on the franchisee’s ability to engage in the same or similar business during and after the termination of the franchise; and the number of outlets created, sold, and closed during the past three years. In addition, if the franchisor makes a financial performance representation, the representation must be disclosed in the FDD.8

Upon its initial adoption, the amendments to the Rule were analyzed in a CCH Publication entitled “FTC Disclosure Rules for Franchising and Business Opportunities.”9 A comprehensive review and practitioner’s guide for the Amended Rule was recently published by the ABA Forum on Franchising.10

Closely allied to the Commission is the North American Securities Administrators Association (“NASAA”). Formed in 1919, NASAA is the oldest international organization dedicated to investor protection including securities, franchise and certain other investments and includes 67 state, provincial and territorial securities administrators in North America and Mexico. Within this broader group, fourteen states require disclosure to prospective franchisees and twelve of these states are members of NASAA regarding franchise disclosure and registration. Many of these states require registration prior to sales activities, while other states alternatively require only presale franchise disclosure. Still other states require registration or both registration and disclosure under business opportunities laws. The current version of the FTC Rule does not permit the application of state laws that are inconsistent with the FTC Rule disclosures, but does not preempt any equal or greater protections not inconsistent with the FTC Rule.11 NASAA has provided commentaries for use by franchise law practitioners including

8 84 Fed. Reg. 9,051 (footnotes omitted).
11 16 CFR Part 436.10(c).
commentaries on financial performance representations,\textsuperscript{12} franchise multi-unit franchises,\textsuperscript{13} and a new franchise state cover sheet to the disclosure document.\textsuperscript{14}

II. THE REQUEST FOR PUBLIC COMMENT

The request for public comment was broken down into thirteen questions; several of the questions included sub-questions. Many of these questions sought empirical evidence in support of the benefits and costs of existing provisions as well as proposed changes. These latter sub-questions on evidence, benefits and costs were often not answered or were answered summarily by the commentator. The authors of this paper will therefore not address these sub-questions separately, but as appropriate will mention these topics when addressing proposed changes.

III. AN OVERVIEW OF THE PUBLIC RECORD COMMENTS TO DATE

Forty-one comments were filed with the Commission by the May 13, 2019 deadline.\textsuperscript{15} Several of the comments were short, but other comments included a very detailed analysis of a wide range of topics. Comments were received from both the franchisor and franchisee communities, including organizations such as the International Franchise Association (“IFA”) and the Coalition of Franchisee Associations (“CFA”). Comments were received from franchisees and franchisors and legal counsel, including many members of the ABA Forum on Franchising.

A. Comments in Response to Specific FTC Questions

The FTC’s request for public comment is presented in the form of specific questions. The FTC’s questions are set forth below in bold text, followed by a discussion of some of the public responses that have been submitted. Some topics were addressed by commentators in response to different questions. We have attempted to consolidate public comments with the topics we considered most relevant but the varying approaches taken to the FTC’s questions has led to some unavoidable repetition as similar issues were raised in different contexts.

In the following sections, after a discussion of the public comments submitted in response to specific questions, the authors have submitted their own comments under the captions of Selected Franchisee Perspective (Lagarias) and Selected Franchisor Perspective (Solish). It is important to note that these perspectives are not always discordant. Both authors share the view that it is fundamentally important that prospective franchisees are provided with meaningful information in a format that is understandable and readily accessible to them.

---

\textsuperscript{12} http://www.nasaa.org/industry-resources/corporation-finance/franchise-resources.


\textsuperscript{14} http://www.nasaa.org/wp-content/uploads/2019/05/New-Franchise-State-Cover-Sheets-Instructions.pdf

\textsuperscript{15} This paper references commentators by the last name of the author, with occasional additional references to organizations affiliated with a commentator, such as the IFA and the CFA. The authors note that they both submitted comments: Peter C. Lagarias is referred to as Lagarias; Jonathan Solish is referred to as Solish.
B. Is There a Continuing Need for the Rule? Why or Why Not?

All forty-one submissions support continuation of the Rule. Among those supporting continuation of the FTC Rule are the IFA and several franchisor counsel and franchisors; a bipartisan eighteen members of Congress; and numerous franchisee advocates and franchisees.

The IFA concludes: “However, even as now written, the Rule should be treated as inviolate and essential to the continued growth and success of the franchise model.” The IFA position is supported by ten letters of franchisors or their counsel. These nearly identical letters set forth support for “[t]he Rule in substantially its current format.” Two additional letters merely summarily support the IFA position.

One commentator points out that the FTC Rule allows prospective franchisees, capital providers and other businesses to rely on facts disclosed due to the “legal and regulatory consequences if the reporting requirements are inaccurate.” Another commentator also points out that the required disclosures enable franchisees to “make informed and unpressured purchase decisions.”

Multiple franchisee advocates also support continuation of the Rule, but many also recommend substantive changes. Most of these changes involve supplementing the content of the disclosures themselves or the manner and format of the disclosures to make them more accessible and understandable. These proposals are discussed below.

1. Support for the Current Rule—Selected Franchisee Perspective

While all submissions recommend continuation of the Rule, perhaps a better inquiry might be: why should the Rule remain unchanged? The objectives of franchisors behind these comments are not always transparent. Franchisees and their advocates may wonder why the IFA and many in the franchisor community uniformly seek the status quo of the current Rule. Perhaps franchisors have learned how to comply with the current Rule and see benefits from disclosure, particularly when they add disclaimers and other provisions that protect them from liability to unsuccessful franchisees. Franchisees and their advocates may also suspect that franchisors seek cover by being able to assert that franchising is heavily regulated when, instead, few FTC enforcement actions proceed under the Rule. Franchisee advocates’ proposals for change may, however, involve clearer objectives. Many of those franchisee proposals, outlined below, seek to strengthen perceived inadequacies in the current disclosure and anti-fraud aspects of the Rule.

---

16 Haller (IFA), p. 6.
17 Bailey (FranNet); Barton; Chait; Chase; Geisler; Graves; Kunzelman; Leff; Monson; Sun.
18 Hansen; Vines.
19 Johnson (FRANdata).
20 Anthony Geisler (“Geisler”).
2. Support for the Rule—Selected Franchisor Perspective

For decades, franchisors have been required to compile and provide very detailed information according to very precise guidelines in the course of developing their disclosure documents. The FTC has revisited the substance of required disclosures before and is in the process of considering further revisions now. Franchisors are required by law to comply with the Rule. The process is expensive for franchisors but has become a necessary part of the franchise sales process.

Under the present rules, the franchise model has generally flourished to the point where there are thousands of successful franchise systems in which both franchisors and franchisees are able to prosper. Whether or not the Rule is perfect in its present form, it has helped to create a wholesome environment for the development of successful franchise systems. There is, therefore, no cause for attributing unwholesome motives to franchisors who support the current form of the Rule. Because the current balance between franchisee rights and franchisor obligations has allowed the franchise model to continue to expand and prosper, there is ample justification for leaving things as they are, for the most part.

C. What Benefits, if Any, Has the Rule Provided to Prospective Franchisees, Including Small Businesses? What Evidence Supports the Asserted Benefits?

Multiple franchisor advocates supporting continuation of the Rule acknowledge that it is necessary to provide relevant and valuable information to prospective franchisees. Without such disclosure, these franchisors conclude the following unacceptable results will follow: “uninformed business decisions, distrust, investment losses, litigation and additional government regulation.”

Several comments reflect the view that: “We believe that the Franchise Rule currently serves—and in the past has served—its intended regulatory purpose: to provide significant and important pre-sale disclosure to prospective franchisees. These disclosure requirements not only benefit prospective franchisees, but they also provide the basis for an across-the-board industry standard that all legitimate franchisors must meet.”

The statement on behalf of NASAA comprehensively describes six benefits arising from the continued use of the Rule:

A. It serves as a deterrent against fraudulent and deceptive practices in the offer and sale of franchises;
B. It helps prospective franchisees make informed investment decisions;
C. It gives consumers a starting point to conduct their own due diligence and to verify the accuracy and completeness of information provided to them by franchisors and their agents;
D. It enables prospective franchisees to comparison shop and contrast disclosures provided by franchisors in whom they have an interest;
E. It benefits franchisors by increasing investor confidence in the franchise industry; and

---

21 Plave, p. 2.
F. It encourages uniformity by having a uniformly accepted document for FDDs throughout the U.S.\(^\text{22}\)

D. **What Modifications, if Any, Should be Made to the Rule to Increase its Benefits to Prospective Franchisees, Including Small Businesses?**

Franchisee advocates present multiple proposed modifications on substantive and procedural issues and the formatting of disclosures. The substantive modifications include: a ban on disclaimers, non-representation, and non-reliance provisions in FDDs; a ban on mandatory pre-dispute arbitration clauses, and changes to all of the 23 items of disclosure; and pleas for more readable and understandable disclosure documents.

Several commentators recommend that disclaimers, non-representation and non-reliance provisions be banned from FDDs.\(^\text{23}\) One comment stated: “Use of disclaimers in FDDs should stop. The purpose of the FTC Franchise Rule is to promote the disclosure of information not to facilitate misrepresentations in the sale of franchises. But disclaimers do just that.”\(^\text{24}\) The comment for NASAA also noted that: “the FDD is a tool that franchisors use to defend themselves against allegations that the franchisor made unlawful pre-sale statements, misrepresentations or omissions of material fact.”\(^\text{25}\)

1. **The Effect of Disclosures and Disclaimers—Selected Franchisee Perspective**

Franchisees often claim to have suffered from receiving and relying on false representations and omissions made in the sales process because franchisors have included disclaimers, no representation and no reliance clauses in their FDDs and appended franchise agreements. The law is clear that making financial performance representations outside the FDD violates the Rule notwithstanding disclaimers in the FDD or franchise agreement.\(^\text{26}\) But franchisors universally include the disclaimers in their FDDs and appended documents because they have in some instances been successful negating common law fraud and even state franchise disclosure law claims by the use of such disclaimers.\(^\text{27}\)

The Rule’s purpose is to provide information to prospective buyers, not to provide franchisors with a means to accomplish a fraud. Yet, in the view of many franchisee advocates, this is precisely what “no representation” and “no reliance” statements in FDDs are intended to do. They allow the franchisor and its salespersons to make misrepresentations verbally, or even in writing, outside the FDD, and then dismiss those misrepresentations summarily based on their fine print provisions. Franchisees and their advocates do not believe that franchisors

\(^{22}\) Pieciak (NASAA), p. 2.

\(^{23}\) Fichter, p. 8; Lagarias, p. 8-13; Miller, p. 2; Motta/Chally (CFA), p. 2; Anonymous, p. 2.

\(^{24}\) Lagarias, p. 12.

\(^{25}\) Pieciak (NASAA), p. 4.


should be able to claim that their salespeople were not authorized to make misrepresentations that were not included in FDDs. Salespeople are the franchisor’s agents in the sale of franchises. A franchisor should be responsible for its misrepresentations and omissions, notwithstanding fine print disclaimers; if a franchisor wants to avoid liability, it should police its salespeople rather than disavowing their conduct in its disclosure documents.

Franchisee advocates argue that the Commission should prohibit disclaimers in FDDs so that they are not available as “get out of jail” cards for franchisors. Otherwise, a franchisor can provide a disclaimer in its FDD that no financial performance representations are being made outside the FDD and that the franchisee is not relying on any financial performance representations outside the FDD. Then the franchisor, through its salespersons or even officers, may provide sales and profit data orally, in emails or pro formas, and summarily defend any claims of fraud in the financial data under state law in many states. Such disclaimer conduct makes the Item 19 disclosure requirement into a meaningless farce.

2. **The Effect of Disclosures and Disclaimers—Selected Franchisor Perspective**

Although the Rule was initially adopted to protect franchisees, the extensive pre-contractual exchange of information mandated by franchise disclosure laws casts a long shadow over fraud claims in litigation.\(^{28}\) Suppose, for example, that a hypothetical FDD accurately presents the operating data on 1,735 existing locations across the country—average gross revenues are $1.6 million per location—but the document also discloses that there are 38 locations with gross revenues of less than $600,000 and 210 locations that have failed in the past five years. The franchisor discloses these facts because the Rule requires it. From the required disclosures, however, flow certain legal consequences.

Once a prospective franchisee has read the FDD (or even if the franchisee has failed to read it), the information has seen the light of day. Assume the information disclosed is entirely accurate and properly drawn from actual operating data. Before signing the franchise contract, the franchisee either knew, or would have known had the document been read, that not every location generates $1.6 million in gross revenues—most do, but 38 made less than half of that and more than 10% were failures. In a subsequent fraud claim, the franchisee would like to assert that he or she relied upon the overwhelming implication of data that it was very likely that a new location would generate $1.6 million in gross revenues. This may have been a conservative assumption in generating a *pro forma* at the inception of the relationship and it may have been enough to warrant a business loan to fund the franchise, but the performance information that had been provided was not entirely positive. The franchisee also had to appreciate that not every location had been successful and that there was a risk that a new location could well suffer the same fate.

The franchisee is much like a products liability plaintiff in a prescription drug side-effect case. Taking the hypothetical case of a drug manufacturer, Placebo Company. Federal law might require disclosure on television ads and in pamphlets provided with its Cure-all capsule that common side-effects include lumbago, crossed-eyes, loss of memory, incontinence and suicidal tendencies. As with the FTC Rule case, the disclosures were made in accordance with legal obligations intended to protect the buyer only.

\(^{28}\) See Solish, p. 2.
But in both cases, once disclosure has been made, there are legal consequences that cannot be avoided. Before he could even use the Cure-all product, the patient had received an express warning—whether listened to or read—that told him there were adverse consequences. He and his doctor chose to accept a disclosed risk. If the patient’s eyes subsequently cross, it is only because he proved to be one of the unlucky ones who suffered from unwanted side-effects about which he had received accurate warnings before his purchase of the product. Even if the FTC and the Food and Drug Administration had no interest whatsoever in protecting the interests of companies required to make disclosures under their rules, the disclosures that are actually made necessarily change the parties’ positions in a court of law.

At the end of the day, there are no perfect franchises that are guaranteed to generate great wealth in every instance, and there are no prescription drugs whose use does not sometimes lead to unwanted consequences. If the law’s purpose is to give plaintiffs stronger fraud claims, then there should be no required pre-contract disclosures so that a plaintiff can claim reasonable reliance on the rosy picture painted for him in the sales process. But if disclosures are required by the law, a plaintiff cannot still claim reasonable reliance on a state of affairs that was directly contradicted by information he had before signing the franchise contract.

E. The Proposed Ban of Mandatory Arbitration Clauses

Two commentators recommend that pre-dispute arbitration clauses should be banned from franchise agreements.29 One commentator observes that the hostility of state regulators to arbitration agreements raises significant preemption issues.30 Generally, any state law that discriminates on its face against arbitration agreements is preempted by the Federal Arbitration Act (“FAA”).31

1. Selected Franchisee Perspective

Many franchisees signing a franchise agreement have little understanding of mandatory arbitration. Many are unaware that they are waiving their right to a jury trial, and indeed do not think about such a possible distant and unpleasant occurrence, especially following the high of Discovery Day in the franchise sales process. Even those with some general knowledge are not aware of the FAA and the Supreme Court case law that enforces mandatory arbitration provisions notwithstanding state laws designed to void out of state arbitration and bars class and group actions when specified in the arbitration agreement.33 Franchisees with full understanding and bargaining power likely would not agree to mandatory arbitration especially with out of state venue and waiver of group and class actions.

Could the Commission issue a regulation, notwithstanding the FAA? First, the FTC could study evidence showing that mandatory arbitration provisions have led to deception or unfairness. Already state courts have found several arbitration clauses in franchise agreements

29 Miller, p. 2; Motta/Chally (CFA), p. 2.
30 Sentell, p. 7.
33 AT&T Mobility, LLC v, Concepcion, 563 U.S. 333, 131 S.Ct. 1740, 179 L.Ed.2d 742 (2011).
to be unconscionable and unenforceable.\textsuperscript{34} One could then contend that there is no conflict between the FTC Act, which bans unfair and deceptive practices, and the FAA that enforces agreements to arbitrate. If the FTC were to bar the sale of franchise agreements or consumer contracts with mandatory arbitration clauses, one could argue that no arbitration agreement would be denied enforcement because no such agreement was ever created.

2. \textbf{Selected Franchisor Perspective}

The first generally applicable franchise disclosure statute in the country, California's Franchise Investment Law ("CFIL"),\textsuperscript{35} attempted to do exactly what has been proposed. In its original form the statute prohibited mandatory arbitration clauses in franchise agreements. In \textit{Keating v. Southland Corporation},\textsuperscript{36} the Supreme Court held that the provision in the CFIL that barred mandatory arbitration clauses in franchise agreements was barred by Supremacy Clause. It follows that the FTC probably does not have the power to bar mandatory arbitration clauses in franchise agreements. \textit{Keating} was decided in 1984; since then, the Supreme Court has become increasingly more protective of the FAA. Whatever the relative merits of arbitration might be, the FTC is not likely to bar mandatory arbitration clauses in franchise agreements when the Court has already held that the right to do so is preempted by the FAA.

IV. \textbf{Comments on Required Rule Disclosures Item by Item}

\textbf{Item 1 – Franchisor and Any Parents, Predecessors and Affiliates}

Two counsel primarily representing franchisees present proposals regarding this disclosure about franchisors. Both recommend that disclosure specify any private equity or venture capital ownership of the franchisor.\textsuperscript{37} Both also propose that all guarantors, or the lack thereof, of franchisor obligations be disclosed.\textsuperscript{38} These comments reflect concern over disclosure of corporate structures surrounding franchisors because in their view: “Wall Street strips the company’s cash and assets and leaves the franchisor unable to provide even minimal support to its franchisees.”\textsuperscript{39}

\textsuperscript{34} \textit{Independent Association of Mailbox Center Owners v. Superior Court}, 133 Cal.App.4\textsuperscript{th} 396, 34 Cal.Rptr. 3d 659; \textit{Bridge Fund Capital Corp. v. Fastbucks Corp.}, 2008 WL 3876341 (E.D. Cal. 2008), aff'd, 622 F.3d 996 (9\textsuperscript{th} Cir. 2010); \textit{McGuire v. Coolbrands Smoothies Franchise}, LLC, 2007 WL 238 1545 (2007). Mr. Lagarias was counsel to the franchisees in all of these cases. In \textit{Bolter v. Superior Court}, 87 Cal.App. 4\textsuperscript{th} 900, 104 Cal.Rptr. 900 (2001), an out of state venue clause in an arbitration agreement was held unconscionable in a franchise dispute.

\textsuperscript{35} California Corporations Code, section 31000, \textit{et. seq.}


\textsuperscript{37} Bundy, p. 6; Fichter, p. 3.

\textsuperscript{38} Bundy, p. 6-7; Fichter, p. 3-4.

\textsuperscript{39} Bundy, p. 6.
Item 2 – Business Experience

One commentator proposes disclosure of control persons of parent or affiliate companies that control a franchisor.40

Item 3 – Litigation

Three commentators question the adequacy of disclosures of arbitration decisions, settlements, or sometimes even the nature of litigation and other disputes.41 One commentator’s proposal to address the problem of sanitized listing of lawsuits initiated by the franchisors is to provide a link to the actual pleadings and decisions involving the franchisor.42 Another commentator proposes requiring franchisors to state that the amount of claims advanced by each party and the monetary value of amounts paid in settlement or award.43 A third proposal requests fuller disclosures of franchisor-initiated litigation for more than one year, including the amounts sought and the amounts obtained in settlement or awards.44

Item 4 Bankruptcy

A comment recommended that bankruptcies of persons connected to controlling entities be disclosed.45

Item 5 – Initial Fees

One comment lamented the presence of multiple fees when FDDs combine single, three-pack, vet-fran, kiosk and other rates.46 The proposed solution is to not permit more than one type of franchise in an FDD.

Item 6 – Other Fees

One comment states that the chart format makes this disclosure more readable, but that sometimes fees are omitted which should be included in this disclosure.47

Item 7 – Estimated Initial Investments

Two franchisee advocates stated that they have often observed disclosures that substantially understated estimated initial investments of franchisors.48 They suggest that

40 Id., p. 7.
41 Id., p. 7-8; Fichter, p. 4-5; Karp/Ayres, p. 4-5.
42 Bundy, p. 8.
43 Fichter, p. 4.
44 Karp/Ayres, p. 4-5.
45 Bundy, p. 8.
46 Bundy, p. 8.
47 Bundy, p. 8-9.
accurate historical data should be provided along with the bases supporting the data. Compounding the understatement problem was the franchisor’s use of footnotes and disclaimers stating that the numbers were only estimates, in an attempt to bar franchisee reliance. One commentator concludes: “These broad disclaimers [of estimates which may vary for the franchisee and should be investigated] perform the clever trick simultaneously providing the prospective franchisee with what seems like real information while also transferring the responsibility of substantiating those estimates to the franchisee and providing the franchisor with a built-in defense if the franchisee later attempts to sue the franchisor for misleading Item 7 estimates.”

### Item 8 – Restrictions on Sources of Products and Services

Two commentators assert that the current disclosures regarding required products and services purchased by franchisees hide the real economics of franchise agreements. They assert that franchisors deprive their franchisees of material information when they fail to clearly and fully disclose rebates or kickbacks. One commentator cites allegations of a pizza franchise supply chain, from *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*, in which franchisees alleged they each had paid from $3,000 to $10,000 per year more for ingredients and supplies than if they purchased the products in an open and competitive market. The franchisor was alleged to have received additional revenues of $450 million from the franchisee purchases.

To address what they characterize as the missing and opaque disclosures of franchisor arrangements with vendors, two commentators suggest in their joint proposal: “First, we recommend that franchisors be required to specify the source, amount, and use of each individual payment received in return for its franchisees' purchases,” and “Second, we recommend that franchisors be required to disclose the precise nature and value of ‘other material consideration’ from vendors, such as free goods or services or more favorable commercial terms than would be available at arm’s length.”

An alternate and more radical approach proposes a mandatory disclosure which, fully and bluntly, tells it like it is. “Except as specifically set forth below, you have no choice about where you purchase any products or services you will use in the business. The franchisor controls all sources and the prices you pay. The franchisor makes a profit on everything you buy whether from the franchisor or an approved vendor. You have no control over your profit margins.” The NASAA State Cover Sheet Guidelines, effective Jan. 1, 2020, will include the statement: “Supplier restriction. You may have to buy or lease items from the franchisor or a

---

48 Bundy, p. 9-10; Fichter, p. 5-6.
49 Fichter, p. 5.
50 Bundy; Karp/Ayres, p. 5-6.
51 *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*, 124 F.3d 430 (3d Cir. 1997) (franchisee antitrust tie-in sale claims were dismissed in the action).
52 Karp/Ayres, p. 5-6.
53 Bundy, p. 10.
limited group of suppliers the franchisor designates. These items may be more expensive than similar items you could buy on your own.\(^{54}\)

In *Queen City*, the franchise agreement had allowed purchases from competing suppliers but expressly reserved the right to restrict franchisees to purchasing certain products only from Domino’s. Because the contractual restriction was expressly stated, there was no antitrust issue regarding changes in supply restrictions to locked-in buyers. If the franchise agreement allows the franchisor to designate itself as the sole supplier of any product, that restriction should be understood before a franchise agreement is signed.

**Item 9 – Franchisee’s Obligations**

One commentator proposes placing Items 9 and 11 next to each other.\(^{55}\) One observation is that franchisees have many obligations while franchisors have few under most current franchise agreements. It has been suggested that a statement should be added to disclosures stating that the franchisor has no obligation to do anything for the franchisee beyond what is expressly stated in these Items. Another idea is to create an embedded link from the disclosure descriptions to actual franchise agreement terms.

**Item 10 – Financing**

One commentator suggests that, while franchisors seldom directly finance franchisee purchases, they do so indirectly.\(^{56}\) This occurs through franchisor recommendations of loan packagers, retirement fund rollover specialists, and bank and Small Business Association (“SBA”) loan personnel. In addition to recommending them, franchisors often supply them financial information for the transactions, although usually with a confidentiality provision requiring that the financial data not be provided to the franchisee. The result: “the loan is approved and funded, [and] the franchisor gets its fees and its margin on all of the equipment, goods and services the franchisee is required to buy.”\(^{57}\) The commentator states that transparency to the prospective franchisee is needed. “The investor needs and deserves to know exactly what the franchisor, through what superficially appears to be arm’s-length intermediaries, is telling the financing source.”\(^{58}\)

**A. Disclosure of Franchisor Representations to Banks—Selected Franchisee Perspective**

This comment about a single seemingly obscure disclosure raises a serious franchisee disclosure and protection issue. The franchisee is not just investing risk capital, but also placing all of her assets and personal credit at risk when entering into loans. Yet the franchisee is not being provided the financial data and representations—emanating from the franchisor—being used to obtain those loans. Nor is this an abstract problem. For many years—when the SBA


\(^{55}\) Bundy, p. 10-11.

\(^{56}\) Bundy, p. 10-11.

\(^{57}\) Bundy, p. 11.

\(^{58}\) Bundy, p. 11.
provided the data—certain franchise systems had failure rates of as high as 20, 40, even 60% of the SBA guaranteed loans used to enter into franchise agreements. Each of these loan failures represents a crisis for the franchisee—typically loss of the franchise business; loss of franchisee’s collateral; loss of franchisee’s credit; and personal bankruptcy.

B. Disclosure of Franchisor Representations to Banks—Selected Franchisor Perspective

No empirical evidence has been submitted that franchisors have provided false statements to banks. A franchisor doing so would probably be liable for bank fraud. In the absence of any showing of an actual problem, there is no need for remediation by the FTC. Further, a prospective franchisee determines which franchise he or she wishes to purchase after a due diligence investigation. A bank’s subsequent approval of a loan is not an endorsement of the wisdom of the franchisee’s investment and, therefore, should not be the subject of pre-sale disclosures.

As to the issue of disclosure of failure rates on SBA loans, there have been news reports that Senator Catherine Cortez Masto (D-Nev.) will be introducing legislation “to require companies like Subway to disclose their rate for defaulted government-backed small business loans to [prospective] franchisees.” Although there might be reasons to track SBA loan failure rates for various franchise systems, a prospective franchisee should be concerned only with the franchise failure rate over the past three years, not with the source of loan funds for failed franchisees. There is no causal connection between the source of funds and business failure. It should not matter whether funds came from the failed franchisee’s own savings account or from the SBA. Because the failure rate of the franchise is already covered in Item 20, there is no need to require further disclosures about the source of funding for failed franchisees.

Item 11—Franchisor’s Assistance, Advertising, Computer Systems and Training

The single comment here is discussed in Item 9 above.

Item 12 – Territory

Two commentators, including one from NASAA, question whether the disclosures regarding exclusive territory are confusing. NASAA finds that the term “exclusive territory” can be confusing because many franchise agreements use other terms such as “protected territory” or “limited exclusive territory.” Another comment notes the problem of reservation of rights swallowing up the exclusivity:

Almost always, the franchisor reserves the right to compete with its franchisees through alternate channels, including the internet. According to one of the commentators, Item 12 should, in most cases, be limited to the simple statement: “You will not receive an exclusive


61 Bundy, p. 12-13; Pieciak, p. 6.
territory. You may face competition from other franchisees, from outlets we own, or from other channels of distribution from competitive brands that we control.” Nothing more should be permitted unless the franchisor truly gives exclusive territories.  

Item 13 – Trademarks

A single comment seeks additional disclosure for franchisors that disclose in general terms that a parent or affiliate is the true owner of the trademarks that are licensed to the franchisee. It is proposed that there should be additional disclosure of the nature of the license and the consequences of the relationship, and that perhaps a copy of the license should be attached to the FDD.

Item 14 – Patents, Copyrights and Proprietary Information

The single comment here notes that claims of trade secret and proprietary information are overly broad and amorphous. The commentator proposes that the Commission should require specific descriptions of trade secret and proprietary information.

Item 15 – Obligations to Participate in the Actual Operation of the Franchise Business

One commentator recommends that this information should be changed from text to tabular format with yes or no responses. Due to the sometimes-convoluted requirements, the commentator also recommends that a hyperlink should be provided to the actual franchise agreement provisions.

Item 16 – Restrictions on What the Franchisee May Sell

The single comment here recommends a short statement of disclosure (unless there are exceptions): “You must sell only goods or services we approve or authorize; You must sell all of the goods or services that we approve or authorize; You have no right to determine or change what goods or services you sell.”

Item 17 – Renewal, Termination, Transfer and Dispute Resolution

Two comments recommend different changes to Item 17 disclosures. The first comment concludes that use of the terms “renewal” and “transfer” in charts is inherently misleading given typical provisions in prevailing franchise agreements. Although franchisees commonly agree to sign the “then current franchise agreement” at the end of the term, “the franchisee does not

62 Bundy, p. 12.
63 Bundy, p. 13.
64 Bundy, p. 13-14.
66 Bundy, p. 15.
67 Karp/Ayres, p. 7-8.
know in advance what a single term or condition of the so-called renewal will be." Likewise, given the restrictions and franchisor approval of transfers, the same phrase is viewed as misleading in that context as well. To resolve the misleading nature of these terms, the commentator offers proposals explaining the limits of renewal and transfer.69

The second commentator applauds the use of a chart format for this disclosure as more likely to be understood.70 Next, however, the commentator notes that several endemic controls specified by franchisors are not disclosed separately. The commentator recommends that these items, which should affect the decision to invest, be disclosed, although not necessarily in Item 17:

a. Minimum sales performance;
b. Franchisor’s right to control retail prices;
c. Franchisor’s control of sources of supply;
d. Obligation to lease or buy real estate;
e. Obligation to personally guarantee obligations to franchisor;
f. Obligations of spouse to personally guarantee obligations to franchisor;
g. Expected obligation to personally guarantee obligations to third parties;
h. Obligation of spouse to not compete during term;
i. Obligation of spouse to not compete after term;
j. Obligation to require employees or managers to sign an agreement not to compete;
k. Obligation to require employees or managers to sign nondisclosure agreements; and
l. Restrictions on internet marketing.71

C. Renewal on Then Current Terms—Selected Franchisee Perspective

The problem of the “then-current” franchise agreement being offered at expiration of the initial term is a subset of information imbalance. The prospective franchisee does not consider something ten years away in the glow of marketing and Discovery Day. Moreover, the very term “renewal” itself may be deceptive. Nothing is being renewed. Instead, the new contract, whether with higher royalties and ad fees, no protective territory, new required vendors, or other terms, is all the franchisee may obtain. Hence the word “renewal” perhaps should be replaced with a statement making it clear that, at the end of the franchise term, the franchisor can offer whatever it wants the franchisee to sign, even if the terms are unacceptable for economic or other reasons. Thus, the franchisee should analyze the purchase on the expectation that the entire franchise investment may have to be recovered in the initial term of the agreement.

D. Renewal on Then Current Terms—Selected Franchisor Perspective

G.I. McDougal, Inc. v. Mail Boxes Etc., Inc.72 highlights the issue of renewals on then current terms. The plaintiff had signed a franchise agreement with Mail Boxes Etc. in 1993 that

---

68 Karp/Ayres, p. 7.
69 Karp/Ayres, p. 8.
70 Bundy, p. 14.
71 Bundy, p. 15.
provided for the right to renew on “the same terms and conditions as are contained in the then current Franchise Agreement for the sale of new [Mail Boxes Etc.] Centers.” After the franchise agreement had been signed, in 2001, UPS had purchased the Mail Boxes Etc. system and developed a new model called The UPS Store to which many Mail Boxes franchisees willingly converted. The plaintiff, however, chose not to convert and wished to renew the terms of his franchise under the Mail Boxes Etc. name. When it was time to renew, a franchise under the Mail Boxes Etc. was no longer being offered. The franchisee insisted that it still had the right to renew its Mail Boxes Etc. franchise rather than converting to the new UPS Store model.

The court ruled that the franchise agreement gave the franchisor the right to change the name of the franchise system. The “then current” form of the Mail Boxes Etc. franchise was offered as “The UPS Store.” The franchisee had no right to renew under the Mail Boxes Etc. brand because that model was not the then current form of agreement being offered to new franchisees.

As the commentator notes, the franchisee could not have known when it signed its initial franchise agreement that its renewal rights would be for a different franchise system. From the franchisor’s perspective, a system risks extinction if it cannot change with the times. Blockbuster was a strong franchise system until technology undermined its basic franchise model. Midas Muffler was a strong franchise system until manufacturers began to guarantee new mufflers for the life of the car. If the basic business model was not allowed to change from a focus on mufflers alone, the viability of the system might have been called into question.

**Item 18 – Public Figures**

The single comment asks the Commission to study celebrity endorsement of the franchise system products instead of endorsement of the franchisor and franchises.  

**Item 19 – Financial Performance Disclosures**

Seven commentators recommend, in one form or another, that the financial performance disclosures ("FPR") include mandatory sales and profit and loss data. Similar proposals have been made by franchisee advocates. A number of other recommendations seek to stop deceptive earnings claims made in Item 19, such as “cherry-picking” disclosures. One of the recommendations contains a new proposal that every franchisor be required to submit a break-even analysis. The rationale for mandatory disclosures is summarized in one comment as follows:

No person can or should make a decision to invest $500,000 to $2,000,000 or more in a business venture without having some reliable information about how other units operating under that brand and using that system have performed. The worst of the franchisors

---


73 Bundy, p. 15.

74 Bundy, p 15-17; Fichter, p. 7-9 ; Goldstein, p. 1-13; Karp/Ayres, p. 8-10; Lagarias, p. 4-6; Miller, p. 3; Motta/Chally, p. 4.

will vigorously oppose a mandatory FPR requirement for the same reason they have in the past. They know that, if anyone knew that the current units were making no money or failing, they could not sell franchises. Good franchisors, who give value for all of the fees, already give truthful and complete FPRs. It would not be “killing the franchise industry” for the Commission to shine a bright light on the bad franchisors and if those companies could not fraudulently sell franchises. The Commission has the best opportunity it has ever had to reduce fraud in franchising by mandating FPRs and requiring that they be truthful, accurate and complete – and that they, in fact, have a reasonable basis.76

Similar proposals for mandatory financial performance disclosures especially of profit and loss data were presented in prior reviews of the Rule.77 Although the FTC recognized that false or misleading financial performance representations were the basis of many enforcement actions, the Commission did not believe that mandating performance representations would reduce the level of false claims. Franchisors asserted that they did not have financial performance information from all of their franchisees, or they were concerned over the accuracy and uniformity of data they received from their franchisees.78 Where performance representations were not made by franchisors, information was available to franchisees from other sources and “[m]andating financial performance disclosures would also impose substantial new accounting, data collection, and review costs on all franchise systems. . . .”79 Instead the Commission continued to make financial performance disclosures voluntary but required that, if made, disclosures must have a reasonable basis, and be non-misleading and accurate. The FTC also excluded the disclosure of “cost only” information from the definition of a financial performance claim.80

One commentator suggests that the NASAA Commentary on Item 19 has created a problem by allowing franchisors to exclude financial performance data for units open less than two or three years. He points out that this information may be the most important data needed by prospective franchisees to plan “whether they have enough resources and capital to get to three or four or more years of operational maturity.”81

E. Disclaimers in Financial Performance Representation Claims—Selected Franchisee Perspective

Prospective franchisees buy franchises as business investments, not as hobbies. They want and should be provided sales and profit and loss data from all existing units whether corporate or franchise units. When such information is not provided, they will frequently seek it

76 Bundy, p. 19.


78 Kaufmann, p. 211.

79 72 Federal Register 15498.

80 Id., at 57329.

81 Bundy, p. 16.
from the franchisor and its personnel or from existing franchisees. Prospects may be given false and misleading data outside of Item 19. Why? Because the franchisor wants and needs to make franchise sales and the risks associated with violating the Rule may be minimal. Government actions, especially by the Commission, are few and far between. Private actions may be defeated by disclaimers of additional representations and reliance, including in a potentially expensive arbitration that may be conducted across the country in the franchisor’s home state.

Often, the only other source of data for a franchisee when there is no Item 19 disclosure is other franchisees. But such information is often incomplete or flawed. Many franchisees do not want to provide their personal financial data or may fear franchisor reprisal on providing negative information. The prospect may be steered to an atypical profitable unit. And the franchisee may not be able to obtain and analyze financial data, especially the many first-time franchisees who have never operated a business before.

Those franchisors providing Item 19 disclosures may shape the disclosures to avoid providing a real picture of the viability of the franchise businesses. While a recent study found 56% of franchisors made Item 19 financial disclosures, it did not analyze the type of financial information being disclosed.\(^{82}\) Disclosure of only revenue without profit and loss data may be misleading by omission of material facts. The revenue data may be completely accurate but may hide the losses of the majority of the franchisees and break-even status of many more. Disclosure of units operating two or more years, may hide the substantial losses being incurred in years one and two—losses which are not described in the initial investment disclosures of Item 7 which covers only the expenses through the first three months of operation. One commentator devoted his entire letter to the need for a break-even time disclosure.\(^ {83}\) The comment reflects a concern that prospective franchisees need to know the ramp up time before break-even status, a time in which they will need to continue to contribute additional capital. NASAA has approved additional commentary on financial performance representations that are unfortunately not always followed by franchisors or caught by franchise examiners; for example, cherry picking of highly profitable units and hiding losing ones.\(^ {84}\)

Prospective franchisees need full and accurate revenue and profit and loss data prior to purchase. Without this data, the remainder of the disclosures are incomplete and flawed. And without this data, the bad franchisors with units that are consistently unprofitable, breaking even, or marginally profitable, may be able to sell their franchises that no one would knowingly purchase.

F. Disclaimers in Financial Performance Representation Claims—Selected Franchisor Perspective

Objection has been raised to qualifying financial performance representations with provisos that information from other locations may not predict performance of a new location, or

---

\(^{82}\) Lagarias, p. 4-5, citing Diane Shresha and Rob Bonds, FranCompare’s 20 page Survey on Item 19 Submission for 2018 (Feb. 2019).

\(^{83}\) Goldstein.

\(^{84}\) The NASAA Financial Performance Representation Commentary is located at: http://www.nasaa.org/industry-resources/corporation-finance/franchise-resources.
that results may vary.\textsuperscript{85} Such disclaimers allegedly stand "the Franchise Rule on its head and must end."\textsuperscript{86}

The 2007 revision of the Rule prohibits franchisors from disclaiming or requiring a franchisee to waive reliance on any representation made in a disclosure document or its exhibits or attachments.\textsuperscript{87} The prohibition was considered "necessary to prevent fraud by preserving the truthfulness of information contained in a disclosure document."\textsuperscript{88} In 2007, the FTC considered an outright ban on disclaimers, after weighing the arguments of commentators—many of whom submitted similar comments this year. Balancing the arguments submitted by both sides, the FTC chose to adopt a "limited disclaimer ban, rather than a total ban."\textsuperscript{89}

But there is a more fundamental problem. Anyone who has ever purchased stock or fielded a fantasy football team can appreciate that data of past performance can rarely be extrapolated into future performance. The fact is that no one really knows whether it is reasonable to take past data and project future results—in any context. When franchisors make Item 19 disclosures, the Rule requires the disclosure of very specific information. If the information provided is accurate, no one has been deceived. A warning that "results may vary" offers no protection if historical information is inaccurate. But if the information provided is accurate, there should be no fraud claim arising from providing accurate data, and, therefore, no need to hide behind a disclaimer. As the FTC points out, where data on historical ice cream sales from one market are presented in a sale in a very different market, there is nothing in the limited bar against disclaimers that "would prevent a franchisor from having a prospective franchisee sign a clear and conspicuous acknowledgment that the Florida-based performance representation does not apply to states such as Alaska."\textsuperscript{90} More importantly, a disclaimer may serve a positive role in reminding the potential investor that historical data cannot be relied upon to project the actual sales of a location not yet built and run by an owner who has no track record as an owner of the franchised business.

G. Disclosure of Franchisees’ Financial Performance Data—Selected Franchisee Perspective

Many, and perhaps even most, franchisors require franchisees to provide complete financial data including profit and loss statements and income tax returns for the franchise business. But virtually all franchisors that base royalties on sales volumes require their franchisees to report revenue. Indeed, most systems have a point-of-sale system that provides gross sales data of every franchisee to the franchisor in real time. Such franchisors can request and likely receive profit and loss statements from franchisees, and can alter their franchise agreement to require such information from franchisees signing the amended agreements.

\textsuperscript{85} Karp/Ayres, p. 9.

\textsuperscript{86} Id.

\textsuperscript{87} 72 Federal Register 15530.

\textsuperscript{88} Id., p. 15533.

\textsuperscript{89} Id. at 15534.

\textsuperscript{90} Id. at 15535.
Franchisors can disclose that they have not audited or examined the data from its franchisees. Indeed, if this was such a problem, no franchisor would ever be disclosing profit and loss data from existing franchisees. But some do, and it can be and should be required.

H. Disclosure in Franchisees’ Financial Performance Data—Selected Franchisor Perspective

Through their own outlets and point-of-sale data, franchisors can usually be expected to have accurate data for gross sales, at least to the extent accurately submitted by franchisees. The claimed operational costs of franchisees are a different matter entirely. One commentator suggests that franchisors either “have access, or could through their agreements with franchisees get access” to their cost data. Franchisees have good cause to be tempted to overstate the costs attributable to the operation of a business because they are taxed on any profits. It would certainly not be surprising to learn that some franchisees claim business expenses, including marketing expenses, costs for employing family members who do not always have actual jobs, deduction for various vehicles that may not be used in the business at all and home and personal expenses that they may choose to report as business expenses. This is not to say that franchisees can be expected to cheat, but it is certainly reasonable to question whether the expenses claimed by franchisees would in fact present trustworthy data that a prospective franchisee should rely on in making a business decision.

Franchisors cede the power over the claimed operational expense of running a franchised business to franchisees. If franchisors are then required to disclose data that does not come from their own records but comes from the records of completely unrelated parties—their franchisees—they will be providing disclosures to prospective franchisees from data that the franchisors do not control and that is almost certainly unreliable. It would be unfair to force franchisors to disclose unreliable data, especially when prospective franchisees can sue if disclosures are misleading or inaccurate.

Item 20 – Outlets and Franchisee Information

Multiple franchisee advocates seek improvements to Item 20 disclosures about franchise outlet histories and contact information. Several express concern that accurate disclosures of turnovers and failures of previous franchise outlets were not being disclosed. Another proposal suggested multi-year disclosures including a rolling ten-year turnover disclosure. One recommendation was for a uniform turnover disclosure:

We urge the FTC to seize the opportunity to create an industry-wide definition of turnover rates of both company-owned and franchised outlets, ending the controversy over this vital statistic and creating the ability for prospective franchisees to compare systems in a meaningful fashion. The Franchise Rule does not provide

---

91 Goldstein, p. 6.

92 Bundy, p. 19-20; Karp/Ayres, p. 10-13; Lagarias, p. 7; Miller, p. 3-4; Motta/Chally (CFA), p. 5-6.

93 Miller, p. 3-4; Motta/Chally (CFA), p. 5-6.
prospective franchisees with an effective means to determine the frequency with which units in the system change hands.\textsuperscript{94}

One commentator suggests that Table 2 on Transfers should also disclose instances where franchisees have requested a transfer that the franchisor has not allowed.\textsuperscript{95}

**Item 21 – Financial Statements**

The single comment here asks for the elimination of the “phase-in” exception to audited financials of the franchisor.\textsuperscript{96}

**Item 22 – Contracts**

This single comment recommends that the Commission proclaim that all agreements the franchisee will be asked to sign must be attached to the FDD.\textsuperscript{97} The author cites examples of software licenses, advertising cooperative agreements and other agreements that were not provided in the FDD, but which franchisees were required to sign later in the relationship or shortly after opening.

**Item 23 – Receipts**

The single commentator requests that the Commission include language next to the prospective franchisee signature on the receipt stating: “Do not back-date.”\textsuperscript{98} In addition, the date of FDD receipt should be blank for the franchisee to enter. The concern is that franchisors might complete a sale before the end of the fourteen day cooling-off period by back-dating the signature of the prospective franchisee.

**Additional Disclosure Item Proposals**

The statement from NASAA contains the most proposals for new information to be included in the FDD. The first proposal is that the Commission incorporate NASAA Commentaries into the Rule.\textsuperscript{99} Between 2009 and 2017, NASAA adopted the following commentaries: the NASAA Commentary on the FTC Rule; the NASAA Franchise Multi-Unit Commentary; and the NASAA Financial Performance Representation Commentary. These commentaries were created by the NASAA Franchise Project Group in consultation with the Commission. The Commentaries were each the subject of public comment periods and often extensive comments. The Commentaries are used by state franchise examiners for registration compliance, and are reportedly studied by franchisor legal counsel. In its comments, NASAA

\textsuperscript{94} Karp/Ayres, p. 11.

\textsuperscript{95} Karp/Ayres, p. 11.

\textsuperscript{96} Bundy, p. 20-21.

\textsuperscript{97} Bundy, p. 21-22.

\textsuperscript{98} Bundy, p. 22.

\textsuperscript{99} Pieciak (NASAA), p. 5-6.
requests incorporation of the Franchise Commentaries into the Rule to codify their well-established guidance and promote uniformity in the franchise marketplace.\textsuperscript{100}

NASAA also recommends that the Commission consider an additional disclosure as to the use of data. NASAA asks for consideration of disclosure of “the value of customer data to the franchise system and the potential value of this data to third parties.”\textsuperscript{101} In addition, given national cases of data breaches, NASAA urges the Commission to examine disclosure of data protection obligations of the parties to franchise relationships and their duties in the event of a data breach.\textsuperscript{102}

I. **Overall Items of Disclosure—Selected Franchisee Perspective**

Several of the 23 Items of disclosure have been subject to franchisee/franchisor commentaries discussed above. Other items of disclosures which have not had such commentaries, are also worthy of consideration, particularly those disclosures that cover factual information. The disclosures describing rights and duties under the appended franchise agreement, as one commentator noted, would benefit from having electronic disclosure with a link to the actual franchise agreement terms.\textsuperscript{103} Such links are routinely created in websites and electronic documents and are worthy of Commission study.

J. **Overall Items of Disclosure—Selected Franchisor Perspective**

Many of the more aggressive commentaries raise issues that were considered and rejected the last time modifications of the Rule were considered and are likely to be rejected again for the same reasons. Considering the vast changes in technology since 2007, the year the first iPhone was released, the focus should be on making the information more readily accessible so that prospective franchisees are more likely to review the information provided to them, rather than on changing required disclosures. It is in the interests of both franchisors and franchisees that the disclosure format is effective in presenting information to prospective franchisees.

V. **WHAT MODIFICATIONS, IF ANY, SHOULD BE MADE TO THE RULE TO INCREASE ITS BENEFITS TO FRANCHISORS AND FRANCHISE SELLERS, INCLUDING SMALL BUSINESSES?**

The IFA reports that a survey of its members revealed unanimous support for the Rule and substantial support (roughly two-thirds of respondents) for no Rule changes at all.\textsuperscript{104} This view was reflected in the statements of many other franchisor-side commentators.

\textsuperscript{100} Pieciak (NASAA), p. 5-6.

\textsuperscript{101} Pieciak (NASAA), p. 7.

\textsuperscript{102} Pieciak (NASAA), p. 7.

\textsuperscript{103} Bundy, p. 15.

\textsuperscript{104} Haller (IFA), p. 2.
VI. WHAT SIGNIFICANT COSTS, IF ANY, INCLUDING COSTS OF COMPLIANCE, HAS THE RULE IMPOSED ON FRANCHISORS AND FRANCHISE SELLERS, INCLUDING SMALL BUSINESSES? WHAT EVIDENCE SUPPORTS THE ASSERTED COSTS?

A franchise consulting firm comments that the costs associated with compliance with the FTC Rule pale in comparison to the benefits of a viable regulatory scheme. 105

VII. WHAT MODIFICATIONS, IF ANY, SHOULD BE MADE TO THE RULE TO REDUCE THE COSTS IMPOSED ON FRANCHISORS AND FRANCHISE SELLERS, INCLUDING SMALL BUSINESSES?

Franchisors assert that they have expended considerable time and effort to comply with the current Rule, and thus contend that any modifications should be carefully weighed against the administrative burden and the resulting confusion that might be created by such changes. 106

VIII. WHAT MODIFICATIONS, IF ANY, SHOULD BE MADE TO THE RULE TO ACCOUNT FOR CHANGES IN RELEVANT TECHNOLOGY OR ECONOMIC CONDITIONS? WHAT EVIDENCE SUPPORTS THE PROPOSED MODIFICATIONS?

One firm points out that technology is certain to evolve over the course of long-term franchise relationships and suggests that allowances be made so that the innovation and adoption of new technologies and methodologies are not stifled. 107 Multiple comments generally addressed the methodology of providing information. Overall these comments recommend the Commission carefully explore alternate electronic methods of disclosure such as toggling and apps. One statement generally supports making the disclosures “more accessible.” 108

A. Concerns that FDDs are Difficult to Read

Several commentators, on both sides of franchise transactions, raised concerns that franchisees often fail to read their disclosure documents. 109 Multiple comments noted that current FDDs are too long and difficult for most prospects to understand. 110 Prospects do not read the documents, and those that do, do not comprehend them, as reported in cited articles. 111 One commentator concludes: “It is now beyond time for the industry and the Commission to take a huge leap into the current millennium and create a communications regime that is readable and that people will read.” 112 The comment from NASAA – from the

105 Johnson (FranData), p. 2.
106 Fisher, p. 2.
107 Plave Koch.
108 Sentell, p. 2.
109 Spandorf, Polsinelli, Solish, Fichter, Lagarias.
110 Bundy, p. 2 (FDDs are 300 page documents); Fichter, p. 2 (FDDs are written by lawyers for lawyers); Lagarias, p. 14-15.
112 Bundy, p. 2.
state franchise examiners who actually read and register compliant FDDs — also expresses this concern. NASAA concludes that FDDs need to improve readability as they are often too long and dense.\textsuperscript{113}

Recent empirical data show that most franchisees ignore their disclosure documents and do not consult a lawyer before signing a franchise contract.\textsuperscript{114} One comment stated:

Despite efforts related to electronic disclosure, the disclosure document itself remains relatively static. It is a lengthy and dense legal document that stretches for hundreds of pages. Many prospective franchisees view the document as “legal fine print” and simply disregard it. We believe additional efforts should be made to ensure that the document itself is capable of being consumed in less traditional formats, including through interactive web-based technologies, mobile applications, and other interactive learning platforms.\textsuperscript{115}

Another commentator, on the other hand, questions the readability standards, suggesting that the use of multi-syllabic words like “advertising”, “franchisor” and “territory”, which are essential to disclosure, may cause the FDD to flunk the readability test.\textsuperscript{116}

One specific comment proposed that a summary disclosure document should be included as a complement, not a replacement, to the current FDD.\textsuperscript{117} The asserted basis for the summary is the sheer length, often between 300 to 500 pages, and complexity of many current FDDs. The goal of the summary is to allow more meaningful review of the disclosures by prospective franchisees. The comment also mentions the Security and Exchange Commission requirement that mutual fund disclosures contain a summary prospectus. The comment includes proposed format and content for the summary disclosure in an FDD:

We recommend that the summary document (1) be provided electronically at the same time as the full document with hyperlinks allowing readers to toggle back and forth between parallel sections with ease; (2) be written in human readable language and be printable for review and retention; (3) be limited to five pages in length and 1,500 words using 12-point font; and (4) contain various simplified charts to conserve space and present data clearly.\textsuperscript{118}

\begin{itemize}
    \item \textsuperscript{113} Pieciak (NASAA), p. 3-5.
    \item \textsuperscript{114} Spandorf, p. 3, citing Robert W. Emerson and Uri Benoliel, \textit{Are Franchisees Well-Informed Revisiting the Debate Over Franchise Relationship Laws}, 76 Albany L. Rev. 193, 210 (2013).
    \item \textsuperscript{115} Sentell, p. 7.
    \item \textsuperscript{116} Zwisler, p. 2-3.
    \item \textsuperscript{117} Karp/Ayres, p. 2-3.
    \item \textsuperscript{118} Karp/Ayres, p. 2 (and referencing Eric H. Karp and Ari N. Stern, \textit{A Proposal for Mandatory Summary Franchise Disclosure Document}, 35 Franchise L.J. 541 (2016)).
\end{itemize}
This summary disclosure proposal was recommended by several other commentators, but criticized by another commentator.\textsuperscript{119}

Another commentator also notes that “very little comparison shopping occurs in the franchise market.”\textsuperscript{120} This commentator attributes the problem to “cognitive failures and heuristic crutches” that lead franchisees to conclude there is nothing to be gained by further searches so that “their Stiglerian search equilibration is frequently out of whack.”\textsuperscript{121} Another commentator points out, however, that even if there are “instances of willful blindness or lack of diligence” in franchising, the same is true as to many buying decisions, whether cars, homes or investment opportunities.\textsuperscript{122}

One set of responders inquired about use of other technology and formats, such as electronic disclosure.\textsuperscript{123} The goal of additional formats is to ease the use of the disclosures, but little was provided on the details of such electronic formats. One commentator recommended that all disclosures should be electronic and searchable.\textsuperscript{124} The basis for the latter comment was the commentator’s conclusion that most individuals under the age of fifty obtain most of their information from the Internet.

The NASAA submission asked the Commission to provide further guidance of electronic links within disclosure documents.\textsuperscript{125} While a footnote to the Statement of Basis and Purpose prohibits franchisors from selective use of navigational tools for the franchisor’s own benefit, other guidance is lacking over scroll bars, internal links, and search features in electronic disclosures.\textsuperscript{126} In another comment, NASAA expresses concerns that social media may be misused. For example, Twitter character limitations may make full disclosure impossible given the maximum content allowed.\textsuperscript{127}

1. Joint Commentary on the State of Readability and Delivery of Information

Most disclosure laws are based upon the needs of purchasers in the early 1970s when additional information about a franchisor could be obtained only in libraries. A prospective franchisee in 1978 wishing to find out something about Arby’s or Baskin Robbins might have been able to find a short history of the brand in a very well-stocked library at that time but

\textsuperscript{119} Lagarias, p. 15; Sentell, p. 2; per contra, Zwisler, p. 3.
\textsuperscript{120} Goldstein, p. 5.
\textsuperscript{121} Id.
\textsuperscript{122} Wall, p. 2.
\textsuperscript{123} Bundy; Fichter; Karp/Ayres; Lagarias.
\textsuperscript{124} Bundy, p. 3-4. ("Disclosure Needs to go Digital").
\textsuperscript{125} Pieciak (NASAA), p. 9.
\textsuperscript{126} Id.
\textsuperscript{127} Pieciak (NASAA), p. 8.
probably would have had to depend almost entirely on what they learned from the potential franchisor to determine the suitability of the franchise investment.

In 1978, it would not have been possible to check the litigation docket sheets of a company in all state and federal courts, or to quickly locate legal decisions mentioning the company or its principals. Legal decisions were then indexed on the basis of categories such as “landlord and tenant” and “breach of contract,” rather than by the names of individuals or brands. Corpus Juris Secundum, for example, has about 400 indexed topics, but had no cross-reference to a specific brand or individual person.

Today, many people research through the internet, where voluminous information—accurate or not—is readily available. A prospective franchisee can now type in the name of the franchise system and easily gain access to information about litigation, the personal histories of officers, franchisee associations, regulatory issues, the industry, trends, pending litigation, websites established by disenchanted system franchisees, news reports, discussions with stock analysts, warnings about the system posted by franchise consultants, and detailed industry postings of earnings and relative rankings compared to competitors, providing comparative costs and anticipated profits by brand. Today, it is possible to obtain a good deal of relevant information from a simple Google search about a franchise brand. Google searches of individuals involved in the company may yield dozens of news reports, providing a wide range of information that might not appear in a disclosure document.

Today, because so much reading is done on the internet, where an attentive reader must learn to quickly skim relevant passages and disregard the rest, attention must jump from screen to screen as the reader moves to more specific information. Cognitive studies would probably show that today’s internet readers rarely read hundreds of pages serially in a single document.128 Studies have shown that when people are overwhelmed with too much information they tend to simply stop reading.129

2. Formatting of Disclosures and Technology—Selected Franchisee Perspective

Franchisees would argue that the current system is not working. Disclosures are too old school, too dense, too wordy, and command the reader to cease reading. Millennials and those even younger are used to documents and websites from which they can scroll, and toggle back and forth, to obtain information. Even baby boomers are likely to decline to read the voluminous document. This is akin to Chief Justice John Roberts admitting that he usually does not read computer website approval forms and literature accompanying medications.130 Arguably, no one but highly specialized franchise attorneys can and will read and understand the current FDDs and appended agreements.


129 Id.

130 Debra Cassus Weiss, Chief Justice Roberts Admits He Doesn’t Read the Computer Fine Print, ABA Journal, October 20, 2010.
Franchisees also assert that the Commission should mandate electronic disclosure in a meaningful way so that prospective franchisees will have modern electronic tools to review the disclosures. At a minimum this should require an index and summary disclosures. The reader should be empowered to toggle between the index and summary disclosures and the full text of disclosures. This will allow bite sized information to encourage reading. There are already two sources for summary disclosures. First, NASAA has adopted a New Franchise State Cover Sheet Instruction. These instructions include navigation guidelines and overviews of the disclosure document. Second, a 2016 Franchise Law Journal article contains a proposal for a summary disclosure format to be included in an FDD.

The use of electronic disclosure should also allow for comparison shopping which is not easily available today. A database with all franchisor disclosure documents could be searched and reports generated. For example, a prospective franchisee could search for all Item 19 financial performance disclosures for pizza franchises. If ten appeared, the franchisee could compare which franchisors made no disclosures, which disclosed only revenues, and the average profit and losses for pizza franchises which disclosed that data. Without purchasing an expensive report this is not possible today.

The Commission has the opportunity to bring the FDD into the forefront of disclosure through effective use and regulation of electronic media. Consider a summary disclosure with links to more detailed disclosure on particular topics. Consider a national searchable database for prospective franchisees. Franchisees could compare five pizza franchises for actual comparison shopping that seldom is feasible today. All five initial investment expenditures could be compared. Next, the financial performance disclosures could be compared. If only three of the five provided such disclosures, the prospect could seriously question why the other two should be considered. Required product purchases and territorial protections could also be compared. Currently, franchisees often cannot make it through a single 500-page disclosure document, let alone compare even a second offering. Moreover, use of such media appropriately may be critical, given that millennials and younger consumers have grown up with them at their fingertips and resist paper tomes.

The other exciting news is that NASAA may lead the way in creating an electronic depository of all franchisor FDDs in registration states. NASAA has already created electronic depositories for other securities registration documents and is now working on one for franchisor FDDs. Stay tuned as this may advance disclosures in franchising.

3. Formatting of Disclosures and Technology—Franchisor Perspective

Although some have advocated that the format of the FDD is fine as it is, it benefits all parties if the format of the FDD becomes more accessible to more prospective franchisees. Franchisors incur considerable expenses in compiling the information included in the FDD and there is nothing to be gained in impeding access to that information. There is no franchisor side of the story that could rationally oppose changes in format that would make the document more

---


133 See, e.g., Zwisler.
readable. If the information that must be disclosed does not change, there’s no harm in making that information more accessible.

At the end of the day, the problem is that some franchisees are overwhelmed by the materials provided to them and are unable to use them. Something is out of whack when many franchisees appear to be unable to make their way through the materials provided to protect them, whether it is because of heuristic crutches or otherwise.\(^{134}\) There are experts in web site design and cognitive studies who have closely studied the formats readers are most likely to review. A re-design of the layout of the disclosure document and the manner in which information may be accessed by the reader may be in order.

The logical order of the disclosure document provides no information likely to compel the reader to continue reading. Some thought should be given to re-ordering the presentation of information in the FDD, moving away from the logically based order of categories into a more accessible structure that could perhaps direct the reader immediately to the most relevant information through hyperlinks or other devices. Even the required form of disavowals is stated in sing-song disclosure language that could as easily appear on the back of a parking lot stub or a mattress pad.

**B. Proposal for Federal Preemption**

In what might be called a standard form of submission filed by quite a few commentators in verbatim text following the IFA format, concerns are expressed that if the FTC abandoned the Franchise Rule, states would replace it with a “burdensome patchwork of rules and regulations” that would make investment decisions more difficult. Former FTC Commissioner Terry Calvani’s warning against such a “crazy patchwork” of different state laws is cited in support of a “consistent national standard.”\(^{135}\)

One commentator is so concerned about conflicting state statutes that she suggests that federal preemption of all state franchise sales laws is in order.\(^{136}\) She sees no empirical evidence showing that state franchise disclosure statutes add any additional protection to the disclosures required by the Rule. She believes that the “consensus within the franchise community is that dual regulation of franchise sales is inefficient, redundant and confusing.”\(^{137}\) She, therefore, proposes that all state disclosure laws should be preempted by a single filing with the FTC. She envisions the deputizing of states to aid the FTC in the enforcement of a single national disclosure law. This proposal would not affect state relationship statutes because the Rule does not apply to ongoing relationships.

In contrast, another commentator presents a franchisee viewpoint noting that there is no conflict between the Rule and state laws.\(^{138}\) Instead, the problem is “the complete lack of any

\(^{134}\) Goldstein, p. 5.

\(^{135}\) American Hotel and Lodging Association (“AHLA”) (Crawford).

\(^{136}\) Spandorf, pp. 1-16.

\(^{137}\) Id.

meaningful enforcement of the Rule. 139 The commentator also argues that statements to courts and arbitrators that the Rule preempts state anti-fraud rules should be a violation of the Rule. 140 Several commentators noted the absence of a private right of action under the Rule. 141 The Coalition of Franchisee Associations states that franchisees put their livelihoods at risk in complaining to the FTC because they fear retaliation. The Coalition also proposes that the FTC should provide special “FTC-designated ‘whistleblower’ status” for franchisees who file FTC complaints. 142

1. Federal Preemption—Selected Franchisee Perspective

The preemption issue was considered during the rule review that led to the 2007 Rule revisions but was rejected on the ground that preemption was a matter for Congress to decide. 143 Under present law, the FTC Rule does not preempt state statutes if they call for more expansive disclosures. 144 Usually, protective federal laws allow states to impose additional requirements for companies doing business in their jurisdictions, as long as they do not impinge on the federal requirements. To weigh the preemption proposal, it would be necessary to determine all of the specific state requirements that go beyond the Rule’s requirements before determining whether these requirements provide more expansive protection for prospective franchisees. State exemptions might complicate this analysis.

The premise of dual registration, as inefficient, redundant and confusing, is inconsistent with the comments of NASAA’s president. 145 His comments mention NASAA’s Franchise Project Group of attorneys from states with franchise registration statutes, noting: “For approximately the last twenty-five years, the franchise registration states and the FTC have followed the same disclosure framework. . . . [and] promote uniformity regarding franchise disclosure requirements.” 146

The California Franchise Investment Law, passed long before the Rule was promulgated, provides for private rights of action, administrative actions and criminal sanctions by prosecutors. Unlike the FTC Rule, state disclosure laws give rise to private rights of action that support civil actions for damages or rescission. States generally have the power to legislate the conduct of companies doing business in their jurisdictions and would probably strongly oppose any attempt to give the Rule preemptive power.

141 Miller, p. 2; Motta/Chally -CFA, p. 2.
142 Motta/Chally -CFA, p. 1.
143 Amended Rule Statement of Basis and Purpose, 15537, note 27.
144 16 CFR Part 436.10(b).
145 Pieciak (NASAA).
146 Pieciak, p. 2.
If preemption would mean giving up the right to sue for violation of disclosure laws, that change is unlikely to be accepted by state regulators or franchisee advocates. State regulators are free to focus on issues that might not be covered by a preemptive federal Rule. It is doubtful that the FTC can create its own preemptive power and it is not clear that states can be stripped of their own power to regulate franchisors doing business within their territories. It is unlikely that the FTC would attempt to do away with state disclosure laws, especially since the FTC has previously said that preemption is a matter for the legislature branch.

State regulators are empowered to, and regularly refuse, registration of incomplete, deceptive and otherwise improper FDDs with particular emphasis on questionable or unsubstantiated financial performance claims. State regulators also impound initial franchise fees of undercapitalized franchisors pending performance. Although criminal prosecutions have not been common in recent years, there is still the statutory power to prosecute under some state laws. There is no right to criminally prosecute under the Rule. While the preemption proposal states that state attorneys general would be empowered by the Commission to enforce its Rule in their states, nothing is stated about private rights of action under the state statutes. Nothing is said about the state statutes providing for criminal enforcement.

2. Federal Preemption—Selected Franchisor Perspective

Preemption of state disclosure laws by the FTC would reduce the burden on franchisors and eliminate the cost of complying with varying state laws and the delays caused by state regulators. Dual registration of franchise sales has been criticized as inefficient and redundant. It is very likely that a single federal filing would streamline the registration process and eliminate the costs and delays caused by compliance with various state laws. Despite those benefits, preemption would face strong opposition from the states and the franchisee bar. In many states, franchisees have statutory rights to sue for rescission or damages for disclosure violations. The preemption proposal suggests that under a single federal filing scheme, the states could be deputized to enforce violations of federal law. That would require the adoption of a whole new set of federal regulations enabling individual private rights of action, which would require a very extensive analysis of existing state causes of action and common law developed around them to ensure that franchisees’ rights were not being eliminated through federal preemption.

If the FTC were to follow the preemption suggestion, it could provide new substantive rights to franchisees in states that do not presently recognize a cause of action for franchise disclosure violations, beyond the general right to sue for fraud. Although that would be a benefit to some franchisees, the franchisee bar and state regulators in states with existing franchise disclosure laws would probably strongly oppose federal preemption.

It is not clear that the FTC would have the right to preempt state disclosure laws, especially if those laws provided greater protections than a new federal disclosure rule. In

---

147 Pieciak (NASAA), p. 1 (“Those states also employ franchise examiners to review and comment on FDDs before the state grants the franchisor an approval registration of its franchise offering.”).

148 Spandorf, 1-16.

1986, the FTC Bureau of Consumer Protection, after years of investigation into state regulations on optometry practice issued its report on Ophthalmic Practice Rules, commonly referred to as “Eyeglasses II.” The report concluded that state restrictions on the practice of optometry, which had prohibited the franchising of optometry stores, were unfair and should be preempted. Care had been taken to draft a recommended rule that would be drawn as narrowly as possible to avoid “any unwarranted intrusion upon the legitimate police powers of the states.”

In *California State Board of Optometry v. FTC*, the FTC’s action was invalidated on the ground that it had acted beyond its statutory authority in attempting to preempt state regulations. Despite the potential benefits that preemption might afford to franchisors, and perhaps to franchisees currently without an avenue for redressing disclosure violations in states without disclosure statutes, it is doubtful that the FTC has the power to preempt state disclosure laws and there is, therefore, no good reason for encouraging it to do so.

C. **Proposed Creation of a Private Right of Action**

1. **Proposed Federal Private Right of Action—Selected Franchisee Perspective**

Case law has rejected a private right of action for violations of the FTC Act. The Commission lacks authority to create a private right of action under the Rule or otherwise, as discussed in detail below. Moreover, even though the Commission provided in its seminal statement of Basis and Purpose that franchisees should have a private right of action under the Rule, at least one court found that this does not establish the requisite Congressional intent to provide a federal private right of action for violations of the Rule.

2. **Proposed Federal Private Right of Action—Selected Franchisor Perspective**

Because the FTC lacks the power to create a private right of action, there is nothing to be gained in asking it to attempt to do so. When the Rule was first adopted, the FTC tried to create a private right of action through the following pronouncement contained in its Statement of Basis and Purpose:

> The Commission believes that the courts should and will hold that any person injured by a violation of the Rule has a private right of action against the violator under the Federal Trade Commission Act, as amended, and the Rule. The existence of such a right is necessary to protect the members of the class for whose benefits the statute was enacted and the Rule as being

---


151 *Id.*, p. 6.

152 910 F.2d 976 (D.C. Cir. 1990). Jonathan Solish testified before the FTC in the hearings that ultimately resulted in Eyeglasses II.


promulgated, is consistent with the legislative intent of the Congress in enacting the Federal Trade Commission Act, as amended, and is necessary to the enforcement scheme established by the Congress in that Act and to the Commission's own enforcement efforts.\textsuperscript{155}

In \textit{Freedman v. Meldy's, Inc.},\textsuperscript{156} after noting that the Supreme Court has “explicitly rejected arguments that the rules adopted under a statute can themselves provide the source of an implied damages remedy if the statute itself cannot,” the court concluded that “there can be no claim that the FTC's new rules themselves provide the source of the implied right of action.” Thus, the FTC's own pronouncement that courts \textit{should} recognize a private right of action for violation of the Rule could not establish such a right of action. Asking the FTC to make the same case again, when there has been no change in the law, is not going to lead to the creation of a private right of action.

As to the request for special protection for persons filing FTC complaints, franchisees are already protected in many ways from retaliation claims arising from the filing of an FTC complaint. Creating some special protected status for complainants would probably just encourage every franchisee at risk of termination to file just to obtain special protected status. The FTC probably lacks the power to create a private right of action.

\textbf{D. Proposals Regarding Enforcement and that the FTC Extend its Regulation to Franchise Relationship Issues}

One franchisee commentator points out a need for enforcement by federal and state regulators to quell fraudulent franchise sales, given the dearth of such governmental actions.\textsuperscript{157} The basis of the comment is the observation of ongoing fraud and deception in the sale of franchises observed by franchisee counsel versus the lack of federal and state enforcement actions. “There is no enforcement [of the Rule] on the federal level. Enforcement by state governments is toothless and focuses on technical registration violations. To continue the same thing for another 10 to twenty years would be of no value.”\textsuperscript{158} Another commentator recommends vigorous enforcement of the Rule.\textsuperscript{159}

One commentator states that “the FTC should finally abandon its long-standing yet unsupported position that its unfairness jurisdiction cannot and/or should not be extended to address the substance of the franchisee-franchisor relationship.”\textsuperscript{160} Two comments asserted the need for the Commission to invoke its authority to regulate unfair acts and practices affecting franchisees.\textsuperscript{161} The FTC’s refusal to extend its authority to relationship issues is asserted to be

\textsuperscript{156} \textit{id.}, 587 F.Supp. at 662.
\textsuperscript{157} Bundy, p. 3.
\textsuperscript{158} Bundy, p. 5.
\textsuperscript{159} Lagarias, p. 3.
\textsuperscript{160} Karp/Ayers, p. 3.
\textsuperscript{161} Bundy, p. 1-2; Karp/Ayres, p. 3-4.
based upon the “erroneous notion that the typical and remarkably uniform franchise agreements in use today are fair as a matter of law.”\textsuperscript{162} This commentator asserts that franchise agreements have become progressively less favorable to franchisees over the years. The FTC is urged to step in to protect franchisees from “unconscionably one-sided agreements presented on a take-it-or-leave-it basis.”\textsuperscript{163} Substantive franchise agreements contain terms that are described as “grossly unfair, unconscionable and even predatory [franchise contract provisions].”\textsuperscript{164} Another commentator sets forth the continuing information imbalance in franchising as to the meaning of the one-sided adhesion contracts prevalent throughout franchising.\textsuperscript{165} This imbalance is further manipulated by ‘incomplete’ franchise agreements that allow franchisors to add duties and economic burdens on franchisees.\textsuperscript{166}

1. **Proposed Commission Regulation of Franchise Agreement Terms—Selected Franchisee Perspective**

As noted above, the Commission has authority to enact trade regulation rules on hearings regarding unfair or deceptive acts or practices.\textsuperscript{167} While the Commission has to date not done so, multiple states have chosen to regulate various unfair aspects of franchise relationships as diverse as termination, renewal, transfer, encroachment and other contractual relationship issues. So too has Congress regarding two particular industries: gas station franchisees\textsuperscript{168} and car dealerships\textsuperscript{169} have federal protections regarding unfair terminations, non-renewals, and transfers. While franchisors may argue that gas station and car dealership owners have more equity at risk than many other franchisees, they also may have more ability to protect themselves. Yet Congress enacted legislation to protect them from overreaching behavior from their franchisors. The same issues and franchisor conduct exist for all franchisees as evidenced by state franchise legislative findings and statutes.

The Commission is already well aware of the information imbalance in franchising, and in addition to reexamining that topic could hold hearings on unfairness and franchise agreements. The Commission could seek evidence on not only the one-sided nature of modern franchise agreements but their intentionally incomplete nature, and any resultant unfair and devastating impact on franchisees. Such governmental hearings on unfairness in franchising took place in Australia over the past year. The resultant national report by a Joint Committee of

\textsuperscript{162} Id.

\textsuperscript{163} Id.

\textsuperscript{164} Karp/Ayres, p. 3.

\textsuperscript{165} Lagarias, p. 3.


\textsuperscript{167} 15 U.S.C Section 57a.

\textsuperscript{168} 15 U.S.C. Section 2801, et. seq.

\textsuperscript{169} 15 U.S.C. Section 1221, et. seq.
the Australian Parliament found that in addition to stronger pre-sale disclosures, franchisees needed stronger franchise relationship laws.\textsuperscript{170}

2. Proposed Commission Regulation of Franchise Agreement Terms—Selected Franchisor Perspective

The FTC Rule and other franchise legislation could have chosen to focus on terms that were unacceptable in franchise agreements, rather than on pre-contract disclosures, which were initially drawn from securities laws. The Rule might have focused on contractual terms in franchise agreements that it considered to be unfair trade practices—for example, post-term covenants not to compete, choice-of-law provisions, liquidated damages, choice-of-forum provisions, contractual limitations on damages or unreasonable requirements on renewal or transfer. The Rule was not developed in this fashion and, given the many state laws that address these issues, it would make no sense to change the focus of the Rule now. As the FTC stated in 2007, “the Commission declines to attempt to promulgate a franchise relationship law and, further, concludes that the record does not support the promulgation of such a law.”\textsuperscript{171}

Although commentators have complained about the “take-it-or-leave-it” nature of franchise agreements\textsuperscript{172} and unconscionable one-sided terms, franchises are not necessities of life that everyone must have. Although it may be easier to sell a franchise that includes reasonable substantive terms, franchisors are not required to offer their franchises on terms that are objectively reasonable. Many years ago, the Supreme Court upheld antitrust franchise tying claims on the ground that certain franchisors, like Buster Brown Shoes, “were offering such an attractive [franchise] package” that they held market power sufficient to force potential franchisees to buy their franchises.\textsuperscript{173} The law has subsequently taken a different course. No franchisor holds sufficient market power to compel a franchisee to choose its franchise system over its competitors’ offerings.

If a franchisor insists that all of its franchisees must close their stores one day a week, or refuse to sell Playboy magazines or requires franchisees to purchase all of their supplies from the franchisor’s brother-in-law, there is no reason these conditions cannot be imposed, as long as they were disclosed going in. In every business transaction, each party has the right to choose not to do business if the overall business package is not attractive.

When a contract is presented on a take-it-or-leave-it basis, the contract is likely an adhesion contract. The weaker party may have certain arguments available that it might not have had if there had been pre-contract negotiations, but the contract is fully enforceable. Presumably, franchise systems with unreasonable or unfavorable terms will ultimately lose out in the marketplace to competing systems with more reasonable terms.


\textsuperscript{171} Federal Register, v. 72, No. 61 (Rules and Regulations) (March 30, 2007), 15451.

\textsuperscript{172} E.g., Karp/Ayers, pp. 3-4.

E. The “What is a Franchise?” Issue

Every state with franchise legislation has adopted its own definition as to which relationships are franchises. One commentator points out that there are “both marked and subtle differences” between the various definitions as to what is a “franchise.”

Therefore, “the contours of what is or is not a franchise under the Rule remain to this day very hazy around the edges.”

The commentator further notes that the Rule had initially excluded employment relationships from the scope of franchise relationships, but had subsequently eliminated all definitional exclusions.

1. Definition of “Franchise”—Selected Franchisee Perspective

The bus on uniformity in American laws left the station in 1787 when the United States Constitution was enacted. The Constitution recognizes a federal government operating with multiple state governments. Each state is empowered to enact legislation within limits in its jurisdiction. While federal law may occasionally preempt state laws, the police power is inherently of the essence for state governments. Indeed the Tenth Amendment reserves all powers not reserved to the federal government to the states.

Regulation of fraudulent conduct is a quintessential state government function. In addition to common law fraud (often now codified by states) there are any number of state laws which regulate businesses including those that prohibit fraudulent or unfair conduct in franchising. Most states have general proscriptions often called Little FTC Acts. A few states regulate franchises either with disclosure and registration laws or franchise relationship laws. Other states regulate business opportunities. Other states do nothing directly covering franchises, and their Little FTC Acts may not apply as well as limited to consumer transactions.

The definition of a franchise is nearly the same in all franchise disclosure laws including the FTC Rule.

Of course the world might be better for franchisors doing business in multiple states with uniform definitions. But that is the price paid for living in a federal system.

2. Definition of “Franchise”—Selected Franchisor Perspective

In the fifty years since California legislators first sought to define franchise relationships, a lot has transpired. When the “modern” definitions of a “franchise” were codified, times were quite different. Over the years, many hybrid relationships have developed that are not clearly within or outside the apparent ambit of relationships meant to be covered by franchise regulations.

---

174 Spandorf, p. 6.
175 Id.
176 Id.
177 One exception is the Wisconsin Fair Dealership Law, which includes the concept of a “community of interest” not found in many franchise disclosure law definitions of a franchise. Wis. Stat. Section 135.02(3). But Wisconsin also has a Wisconsin Franchise Investment Law with a definition of franchise (without the “community of interest” requirement) akin to most other state laws and the FTC Rule. Wis. Stat. Section 553.03(4)(a).
Many restaurants have created limited partnerships that own a dozen locations operating under the same name and operated by some of the investors. Are these relationships supposed to be covered? Many product distribution companies pay millions of dollars per year for the right to distribute branded products. Which distributorships are inside the franchise tent and which are not meant to be regulated?

The FTC definition covers business relationships where disclosures will be required. Many state definitions have a different focus and mean to protect relationships where one party has invested to the point where the other party has it "over a barrel," so that it must tolerate misconduct to ensure the recoupment of its investment. The objectives of state franchise laws vary in details that may be determinative as to whether the state meant to include various relations within the purview of its franchise regulations. Because the purpose of state relationship statutes and the Rule differ, it is unlikely that any change in defining the relationships meant to be included in the Rule would change the ways that various states identify franchise relationships.

Recent cases have examined whether a franchise relationship may constitute an employment relationship under particular statues, suggesting that the exclusions might provide some helpful guidance to courts. 178

The suggestion that the Rule could clarify the differences between employment and franchise relationships is helpful and might help to dispel the recent confusion of some courts as to the significance of franchisor controls in the operation of franchise systems.

IX. CONCLUSION AND WHITHER NOW?

We have focused on the comments and submissions to the Commission about the need for and modifications to the Rule, adding some additional thoughts and perspectives. The merits of such proposals involve matters of policy and will be evaluated taking into consideration the supporting evidence and relative costs and benefits. It has been noted that "there is little reliable data on the effectiveness of disclosure or other regulatory measures for franchising." 179 On the other hand, a Committee of the Australian Parliament received over 400 submissions from franchisees and franchisors, held multiple hearings, and concluded in March of 2019 that strengthen pre-sale disclosures were needed as well as relationship protections for franchisees 180 Ultimately, of course, changes will rest with the determinations of the Commission. Once staff recommendations are received, the Commission will reach a decision on proceeding. To that end, the Commission may file a further notice of rulemaking regarding changes seeking additional comments.


A. Rule Review—Selected Franchisee Perspective

The objective of the seminal Rule was to provide material information to prospective franchisees and to prohibit misrepresentations and material omissions in the franchise sales process. The goal was to correct the information imbalance regarding the business and franchise agreement being offered and to quell fraud. Forty years of experience under the Rule, establishes that course corrections, some minor and some more substantial are necessary to achieve the worthy objectives of the Rule. Some of these changes are already being discussed and partially addressed by NASAA, emanating from the franchise administrators and examiners who review FDDs for registration and are also charged with enforcement for violations including deceptive FDDs.

One major change proposed is to move to a more user-friendly electronic format. Franchisees and their advocates argue that the current FDD format of hundreds of pages, including a complex one-sided franchise agreement drafted by the franchisor, is untenable. Chief Justice John Roberts, in addition to admitting that he sometimes does not read form agreements, stated in a college presentation that too much information defeats the purpose of disclosure as no one reads it.181 The use of electronic disclosure with careful summaries and indexing, coupled with toggling can solve this dilemma. The prospect can read the summary and easily link or toggle to the more detailed disclosure item and even to applicable contract terms. Once a detailed item is reviewed, the prospect can return to the summary or index and repeat the process. Marshall McLuhan remarked long ago that “the medium is the message.”182 In franchising, the FDD is the medium; its format should work for millennials as well as older investors. The experienced franchise administrators of NASAA are already examining this critical set of issues for effective disclosure to prospective franchisees.

Franchisee advocates have also proposed multiple changes and sometimes additions to the existing 23 Items of disclosure while at the same time complaining about the problem of prolix and difficult to read and understand FDDs. This seems a paradox. Yet with a change to electronic disclosures with interactive features, further disclosures can be useful and effective. Those additional disclosures should include mandatory profit and loss data. Changes to Item 20 disclosures of transfers, termination and non-renewals are also worthy of consideration. Franchisees invest enormous sums in franchise businesses, often their life savings, and are further often liable for lease, loan, and other long-term obligations. They ought to be able to easily and unequivocally determine franchise offerings that are not viable and fail to break even let alone profit.

Other franchise proposals submitted to the Commission are worthy of consideration. One includes adding to proscribed practices a ban on disclaimers. Franchisors should not be able to add fine print that negates the Rule’s purpose by allowing misrepresentations outside the FDD. Another proposal invites the Commission to utilize its authority to ban unfair or deceptive practices relating to franchisor conduct in addition to disclosures. If nothing else, the time for hearings on the relationship issues in franchising is at hand.


182 See Marshall McLuhan, Quentin Fiore, The Medium is the Massage, Bantam Books (1967). Apparently, the title of the book was actually a typesetter’s mistake but McLuhan chose to leave it unchanged.
B. Rule Review—Selected Franchisor Perspective

The Franchise Rule has provided rules that franchisors have complied with for many decades. In response to an invitation for public comment from the FTC, franchisees and their advocates have made an underwhelming case for the need for any significant changes to the Rule as it presently stands. The FTC lacks the power to create its own private right of action, though it attempted to create such a right at the inception of its involvement in the sales process and failed to convince the courts of its power to do so. There is no point in revisiting that issue. The FAA would preempt any attempt by the FTC to bar mandatory arbitration clauses in franchise agreements, so there is no point in pursuing this suggestion either. The suggestions that disclaimers should be barred from disclosure documents seems to miss the point that it is the substantive disclosures, in and of themselves, that defeat fraud claims because franchisees cannot claim they did not know about facts that were expressly disclosed to them. Disclaimers associated with financial performance representations are often necessary to highlight anomalies and exceptions that might otherwise have been unclear to a prospective franchisee. Courts should have little difficulty separating self-serving disclaimers from legitimate explanations about the meaning of disclosed data.

The sum of ideas submitted by franchisees, franchisee associations and their advocates collectively amount to a failed harvest. Once the impracticable suggestions have been weeded out, not much remains, suggesting that the Rule is serving its purpose in its present form. Suggestions made about making the disclosure document more readable have come from both sides of the table and should be explored and developed to bring the FDD into line with modern technology. There is no real doctrinal divide on this issue.

It serves the interests of all parties if information is provided to prospective franchisees in a format that is most likely to deliver the information in a manner that can be read by modern readers. McLuhan blamed the anxiety of the age on trying to do today’s job with yesterday’s tools and yesterday’s concepts. Because many of the substantive proposals submitted in the public comment phase of the FTC’s review appear unworkable, it would make more sense if the FTC were to focus its attention on modernizing the format of the FDD so that prospective franchisees are more likely to be able to navigate through the document and understand its contents before they make investment decisions.

Peter C. Lagarias is a founding partner of Lagarias, Napell & Dillon, LLP in San Rafael, California. His trial practice consists of representing franchisees and franchisee associations in negotiations, arbitrations, litigation and trials. He is also a mediator and arbitrator. Mr. Lagarias is a Certified Specialist in franchise and distribution law by the Board of Legal Specialization of the State Bar of California. He is a past Co-Chair of the Franchise Law Committee of the State Bar of California and served as a member of the Franchise and Distribution Law Advisory Commission of the State Bar of California. Mr. Lagarias is currently a member of the Governing Committee of the ABA Franchise Forum, and an attorney adviser to the Franchise and Business Opportunity Project Group and Advisory Committee of the North American Association of Securities Administrators. He is a frequent lecturer and writer on franchise and distribution law, and is the author of *Effective Closing Argument* (Michie 1989), and chapters in the *Antitrust Adviser* (McGraw Hill 1985), *Financial Performance Representations, the New and Updated Earnings Claims* (ABA Forum on Franchising 2008) and *California Franchise Law and Practice* (CEB 2009).

Mr. Lagarias received his B.A. in 1973 from the University of California at Berkeley (Phi Beta Kappa) and his J.D. in 1977 from the University of California, Hastings College of the Law (Order of the Coif, Hastings Law Journal).
Jonathan Solish is a certified franchise and distribution law specialist practicing in the Santa Monica, California office of Bryan Cave Leighton Paisner LLP, an international firm with 1,400 lawyers. He is one of eleven US lawyers included in the Thought Leader Global Elite by WWL. He is in Band 1 in Chambers Franchising Nationwide and Tier 1 in Best Lawyers in America and has been recognized as Franchise Lawyer of the Year by the latter publication in 2011 and 2018. He is in the Franchise Times Franchise Lawyers Hall of Fame.

He was the Editor-in-Chief of the Franchise Law Journal and wrote Franchising (Bloomberg BNA 2017) with his partner, Ken Costello. He served as the Vice-Chair of the IFA Legal Legislative Committee. He wrote the chapter on franchise trials with Michael Dady in Franchise Litigation Handbook (Dennis LaFiura & Griff Towle eds. 2010), is the co-author of Annual Franchise and Distribution Law Developments 2007 and has published more than fifty articles and chapters on franchise law.

Solish has attended every ABA Forum on Franchising Annual Meeting and IFA Annual Legal Symposium since 1984 and has spoken at many of them. Most recently, he was a presenter on storytelling on a panel with the author of My Cousin Vinny in Palm Desert and on the joint employment panel with David Weil, then head of Wage and Hour at the Department of Labor, and Richard Griffin, then General Counsel of the NLRB, in New Orleans.