F.T.C. Public Comment 116

"Gag" order arrangements often form a necessary incentive for franchisors to enter into settlement agreements with franchisees. Gag order arrangements should not be regulated, and they should certainly not be prohibited…It is my belief that the Franchise Rule should not apply to international sales, and I agreed with all of the major points that were made in the original discussions.

	U.S. Federal Trade Commission October 30, 1997 Public Comment Carl Jeffers Request for public comment on possible revisions to The Franchise Rule. Comment #116 FEDERAL TRADE COMMISSION

16 CFR Part 436

Trade Regulations Rule on Disclosure Requirements and Prohibitions Concerning Franchising and
Business Opportunity Ventures

Comments on Proposed Changes to 16 CFR Part 436

The following comments and observations are submitted by Carl Jeffers, President of Intel Marketing System, a franchise consulting firm specializing in franchise structuring and franchise marketing and sales.

The comments will follow the basic chronological order of the discussion of the various subject topics as they appear in The Rule from Point I through IX.

Question/Topic: Should The Rule be amended to require disclosure of lawsuits filed by franchisors against franchisees?

Comment/Response: A specific change in The Rule to require disclosure of lawsuits by franchisors may be unnecessary. As a practical matter franchisor initiated lawsuits are often times viewed favorably by the company as an indication of the company's desire to either enforce its standards, consistency, protection of trademarks, or demonstrate its commitment to taking aggressive action to eliminate continuing violations of the franchise agreement by any deficient franchisees. This approach may be presented as a "positive attribute" of the franchisor

to prospective franchisees, and as a result, many franchisees many hear about franchisor initiated lawsuits even if said litigation is not disclosed in the UFOC.

As a legal consideration, I do not believe there should be a requirement for this particular information to be disclosed as this information does not directly serve the particular purpose of protecting the consumer in franchise transactions, and, particularly with large established franchisors, such a requirement could substantially increase costs for preparation of the material and for the increased document size that would have to result from the inclusion of this material.

Question/Topic: Should "gag" order arrangements be regulated?

Comment/Response: "Gag" order arrangements often form a necessary incentive for franchisors to enter into settlement agreements with franchisees. Gag order arrangements should not be regulated, and they should certainly not be prohibited. With respect to full disclosure to prospective franchisees, a franchisee who has agreed to a "gag" order may not be permitted to discuss the terms of his settlement or litigation with a new prospective franchisee, but he is not prohibited from telling the new prospective franchisee that he is subject to the specific restrictions imposed by a "gag" order. If this information is troubling to the prospective franchisee, he will then pursue it further with the representatives of the franchisor until he is satisfied with respect to this or any other transactions that are subject to "gag" orders.

Question/Topic: Should the Commission continue permitting a three-year phase-in of audited financials for new entrants?

Comment/Response: I definitely believe the three-year phase-in period should be continued. This is a most efficient and fair method of providing financial disclosure and accountability for new franchisors without penalizing them or restricting the entrepreneurial motivation that is an important component. New, emerging franchisors should not be discouraged solely due to financial reporting requirements as opposed to the monitoring of financial stability itself.

Question/Topic: Distinguishing Business Opportunities from franchises?

Comment/Response: It has been established that there is a general consensus that "Business Opportunities" should be distinguished and recognized apart from franchises.

With regard to pre-sale disclosures required of Business Opportunities, I feel it is appropriate that any supplier of 20 percent or more of the start-up inventory of an investor in a Business Opportunity should have to be disclosed prior to the sale.

As an alternative definition of a "Business Opportunity", I would suggest the following definition:

A Business Opportunity is a voluntary arrangement between two parties, where one party (the first party), offers the other party (the second party) participation in the on-going business activity of the first party in an arrangement whereby the second party will commence activities of the same type of those engaged in by the first party but without any required training AND

without the second party having to follow a specific "day-to-day business operating format" as defined by the first party.

Under this definition, the second party agrees to either offer products, goods, or services made available to him through the first party, either directly or through outside vendors and suppliers with whom the first party has established a relationship that is designed in some way to benefit the second party in his pursuit of this activity.

Finally, a transaction would qualify as a "Business Opportunity" if the second party has agreed to pay any one or combination of the following to the first party:

An up-front fee for the opportunity to participate in the arrangement or business opportunity.

An on-going fee based on either gross sales, net sales, or product orders generated by the second party, with the definition for "on-going fees" also to include any fees integrated into the cost paid by the second party for products, goods, or services provided to him by the first party.

The question has been raised as to whether the dollar amount of $500.00 as the "triggering level" of any financial transaction in "Business Opportunity" arrangement should be lowered.

It is my opinion that the $500.00 "triggering level" should not be lowered. At the level of $500.00, virtually all "Business Opportunities" that would be qualified under any of the provisions specified above will be covered as very few, if any, of those types of companies would have structured a fee any lower than $500.00 as a practical reality of the economics of on-going business activity in America.

Question/Topic: Conditional exemption for Trade Show Promoters.

Comment/Response: I agree with those who feel that the Commission should continue to provide an exemption for Trade Show Promoters provided that they make available to attendees at their shows a "specific consumer education notice."

Trade Show Promoters are not franchise brokers nor are they directly or indirectly affiliated with the franchisor exhibitors at their shows. Furthermore, it would be virtually impossible for Trade Show Promoters to determine whether or not franchisors exhibiting in their shows are in complete, partial, or non-compliance with The Rule or any other FTC regulations.

It is possible for Trade Show Promoters to require and to enforce a requirement that all franchisors exhibiting in their shows have "available for public inspection" a current UFOC Offering Circular document. This requirement would mean and should continue to require that each franchisor maintain an actual copy of the UFOC at the booth, not for distribution but rather for "physical examination" by any attendee at the show who requests to see a UFOC.

The franchisors should not be required to distribute copies of the UFOC to attendees at the shows unless a representative of that franchisor engages in a "one-on-one personal meeting" with a show attendee either at a meeting later in the show, or at a meeting during the show away from

the booth premises such as a meeting room, restaurant or concession table area, or a one-on-one meeting behind the booth if arrangements have been made for this type of more involved contact.

Other than the circumstances above, I view all other contacts at the booth between representatives of the franchisor and show attendees as "initial casual encounters" which do not and should not be considered as "first personal meetings." In that context, the franchisor should be required to have on the premises a copy of the UFOC, but he should continue to be exempt from distributing that document unless it is a "bonafide first personal meeting contact."

Furthermore, this particular requirement is one that Trade Show Promoters can enforce and should be held responsible for enforcing on the grounds of their shows.

Beyond these requirements, I do agreed that the Rule should be amended to "specifically exempt" Trade Show Promoters from inclusion in the definition of "Franchise Brokers," and furthermore, Trade Show Promoters should not be held "jointly and severely" liable for Rule violations.

Question/Topic: Earnings disclosure.

Comment/Response: As stated in the review of The Rule, I agree with the problems that have been expressed regarding mandatory earnings claim disclosure.

In addition, it is my belief that no one has mentioned or addressed adequately the problems faced by "new, emerging franchisors" who are just commencing their franchising activity. Clearly, they do not have the track record or historical experience to support any earnings claims that would be presented to prospective franchisees.

With regard to wording to be required as included text in the Circulars of companies that do not disclose or provide earnings claims, I agree with the proposed wording as found in Paragraph 22 of Section E relating to earnings disclosures in the review of The Franchise Rule.

Furthermore, I also agree that it is important to correct the misrepresentation that the FTC Rule actually prohibits the disclosure of earnings claims, and I agree that the additional language indicating that the FTC Rule does permit a franchisor to provide disclosure information about actual or potential sales should be required, and I also believe that the proposed language for franchisors who choose not to disclose any earnings, claims or income potential should also be included and required as part of the text of the offering circular presented to prospective franchisees.

I also feel that the FTC should be cognizant of the dilemma that many franchisors are placed in when they elect not to provide a prospective franchisee with any earnings claims or potential earnings or income information whatsoever.

In fact, very often, it is the "mentality and attitude" of prospective franchisees that is very much a major contributor to this attitude by franchisors.

Prospective franchisees want earnings projections, earnings claims, and any financial information relating to providing them with a "better understanding of what the financial potential is for them in this particular business."

Indeed, from my vantage point in the direct marketing and sales of franchise consulting, I can state categorically that prospective franchisees will continually badger, cajole and otherwise cause representatives of the franchisor to give them all financial projections or earnings potential claims that they feel will "help them either construct a proforma or project a cash-flow for the business."

Franchisors are often reluctant to provide this information simply because the "historical record" of that particular company with respect to its existing stores, or its newness as a franchisor, or other demographic or geographic variations may suggest that it would be unwise to provide information to the prospective franchisee that might mislead that individual.

When this reasoning is explained to franchisees, they will invariably discount that notice and suggest that they understand that these are just projections rather than actuals. They will further insist that they know that there are no guarantees, and they will ultimately suggest that they will only use this information as a "guide" for background preparation for the more "objective" calculations that they will be able to make later on in the process.

Yet, we also know that, once given this type of information, prospective franchisees will invariably want to "hold the franchisor absolutely accountable" if the franchisee does not meet those originally suggested earnings claims or projections once he is open for business.

The franchisor knows this, so if he does give any earnings claims, they may tend to actually be more conservative than they should be and thus not supported by some actual historical figures that reflect higher sales and profits. In this conservative approach, the attitude of the franchisor is supported by his fear of potential litigation.

So on the one hand, if the earnings claims or potential projections are too high or unrealistically high, the franchisee will absolutely hold the franchisor accountable and pursue litigation if that franchisee does not meet those same levels of sales or profits in his own store.

On the other hand, if out of fear of such litigation the franchisor provides earnings claims or projections very low or conservative in order to protect the eventuality of a franchisee not having a stellar location, the prospective franchisee may very often decide that this particular business does not offer enough profit potential and therefore he will pass.

Consequently, caught in that type of dilemma, one can understand why franchisors, in many cases, are reluctant to provide these types of projections or earnings claims at all.

From a practical point of view, I would recommend franchisors take the position with prospective franchisees that although they will not provide earnings claims or potential earnings in the initial period of the franchise and marketing transaction, once the franchise transaction has been consummated and a location has been identified for this particular franchisee to open, the

franchisor would then provide a "low, average, and high" projection of potential earnings based on the "known economic factors such as rent per square foot and the actual size of the location plus other considerations" prior to the actual execution of the lease or purchase offer for said site thus enabling the franchisee to have the kind of information that can really be of assistance to him prior to his making a long-term commitment to a specific location.

The only other alternative that I would recommend would be if franchisors were required to construct a model for three or four sections of the country based on estimates of "rent, average size of location, typical sales as reported by other businesses, and other extra charges such cost of construction, etc.," and then provide this type of model to prospective franchisees with the caveat that it is not only possible but quite likely that the franchisee's actual store will have costs that are different from the model, and furthermore, point out that any single category that varies from the model will potentially void the accuracy of that model for the prospective franchisee's calculations with regard to his own site.

This would at least provide some information to enable a prospective franchisee to gauge the kind of business that this opportunity represents, and it would provide the franchisor with some comfort that they have been provided a limitation on the potential liability based on the "strict exemption of category variations" approach in providing this information to a prospective franchisee.

Question/Topic: Should the Franchise Rule apply to international sales?

Comment/Response: It is my belief that the Franchise Rule should not apply to international sales, and I agreed with all of the major points that were made in the original discussions.

Other countries often have their own indigenous rules and requirements for investments by their own nationals, and in many cases, those requirements would make compliance under our uniform disclosure guidelines virtually impossible.

The current language which essentially states that The Rule "does not reach the sale of franchisees to be located or operated outside the United States, its territories, and possessions," is adequate in defining this exemption and only invites misunderstanding and lack of clarity if additional language is added.

Question/Topic: The internet.

Comment/Response: First of all, despite the suggestion that was made in the text of The Rule Review, I doubt very seriously that franchise sales will ever be significantly conducted "solely" on computer or over the internet without any personal meetings. The fact is, the "first personal meeting" as we know it is not obsolete, and as long as the ultimate transaction involves the franchisee signing a commitment for the kind of financial investment that is required by most franchisors, despite the "visual appeal and development" of internet graphics, sales of this type will not take place without more direct inspection, meetings, and traditional "marketing and sales" techniques.

In my judgment, all of the developing technologies and capabilities represented by the internet and other computer and high-tech inventions only serve to increase the ways that people can "get to the first personal meeting." These developments do not actually replace that first personal meeting.

Furthermore, I would also strongly urge that no change be made in requiring the UFOC disclosure documents to be provided to prospective franchises at the "first personal meeting," but not before that unless there was a financial transaction being made. The fact is, the internet and telephone modems are full of "casual inquiries" from people who have no intention nor could ever qualify enough to even get to the stage of a "first personal meeting."

Franchisors should not have to assume the administrative and financial burden of providing full disclosure documents to all of these people who inquire simply because of the ease of electronic communications.

Question/Topic: "Stream of Revenue" franchises.

Comment/Response: Essentially, "Stream of Revenue" franchises are those where the franchisee buys a set number of either existing or soon to be established accounts from the franchisor, and the fee paid by the franchisee is based on the revenue that these accounts are guaranteed to either provide based on their existing operational experience or will provide based on the franchisor's evaluation of the accounts themselves.

The question posed was whether these types of franchises constitute "earnings claims" and thereby require substantiation of these earnings claims based on the provisions of The Rule.

It is my position that "Stream of Revenue" franchises are absolutely to be considered as "representations of earnings" and should therefore be required to provide the same standard of earnings claims justification, disclosure, and historical validation as is the case with standard earnings claims as presented by other franchisors.

By definition, these "Stream of Revenue" franchises involve a specific promise by the franchisor that the franchisee will either inherit or be provided with a certain level of essentially guaranteed income based on the accounts that he is purchasing. In fact, this goes somewhat beyond an earnings projection or claim. This is, in fact, a statement of earnings that has been "packaged and offered for sale" to the franchisee.

Consequently, not only is this an earnings claim, but it is rather more significantly a "prima facie" case of direct representation by the franchisor of actual earnings the franchisee will obtain.

On that basis, the franchisor is potentially liable not only for earnings claim violations but for actual "breach of contract" if those accounts do not perform.

Clearly, at the very least, this type of "earnings projection" should be subject to at least the same standard of disclosure, historical background, or substantiation that other franchisors must meet when providing the non-"stream of revenue" earnings, claims or projections.

Question/Topic: Co-Branding.

Comment/Response: The question was posed as to what disclosure requirements are necessary in the event the franchisee is purchasing a "Co-Branding" franchise where there is more than one company or business being acquired by the franchisee to operate as a franchise location.

It is my opinion that if both company logos will be equally promoted, and if the franchisee signs a separate franchise agreement with each franchisor, even if the franchisee pays one franchise fee, then the franchisee should be considered as having purchased two individually trademarked franchises and should therefore receive separate disclosures and UFOCs from each franchisor.

The fact is, the business risks are not much different for the franchisee than if he was purchasing one or the other of the two franchises in question, particularly since both will be operated out of the same location that the franchisee might have sought to acquire to operate one or the other of the two businesses separately.

"Hybrid" franchise arrangements are an "enhancement" to an existing franchise model, not a replacement.

Unless the two franchisor companies form a new third-party joint venture franchisor, each of them should be considered as a separate franchisor subject to full disclosure requirements with respect to any new franchisee who desires to open both businesses in a "Co-Branding" setting.

Question/Topic: Revision of The Rule to reduce or waive penalties for infractions.

Comment/Response: I do agree that the FTC should focus its enforcement attention on serious violations that cause "significant consumer injury."

I do recognize the fact that limited resources, both human and financial with respect to budgeting, necessitate at least a review of this option by the FTC.

But, in my judgment, it is important not to confuse franchisors as to what violations or infractions "will be enforced" and which ones will not be.

Nor should the FTC provide, either in fact or by implication, an incentive to franchisors to lessen or reduce their efforts to "come into and remain in full compliance" to the fullest extent possible with the requirements and provisions of the FTC Rule.

Perhaps the FTC can establish an internal policy as to what portion or body of its guidelines or rules will receive less attention and enforcement activity than others, and this decision would obviously reflect the current situation where the agency must deal with a more limited budget with fewer personnel resources to monitor nationwide activities.

Notwithstanding this fact, in the public forum, the FT must take the stance that "The Rule is The Rule," and franchisors must be in full compliance with The Rule or be exempt or obtain a waiver for special circumstances.

By example, we are all aware of the fact that there are some states in the United States that practice a policy of not enforcing seatbelt laws unless the driver has committed some other infraction in addition to the seatbelt violation to justify being pulled over by an officer or highway patrolman.

Notwithstanding this fact of reality in terms of the practical application of the seatbelt law, no state, including those who have the policy indicated above, takes the position that it makes sense to advertise on billboards or T.V. ads the fact that "in our state, we are proud to say that we only enforce seatbelt law violations if some other infraction has been committed."

This policy, even though known, at least provides no absolute guarantee to a "violator" of the seatbelt law that he can "get away with it" as long as no other violation is committed. Yet, as a practical matter, it does make sense for some states and jurisdictions to follow this approach in order to reduce the administrative cost as well as the human resource and financial cost of prosecuting everyone who was violating the seatbelt law but was committing no other infraction.

Finally, in response to the question as to whether there is even a continuing need for The Rule itself, I would suggest that for the overall public good and welfare of the investor community, particularly in the franchise world where so many of the new participants are making their first foray into this type of activity at this high a level of investment, it is important to observe that there have been some startling, positive benefits in the attempt to improve the integrity, honesty, candidness, and viability of the franchise industry since the inception of The Rule almost 18 years ago.

Today, the franchise industry is one of the most important and economically significant industries in America, and with such a major role in the overall economy of our Nation, there must continue to be some oversight, monitoring and review of the "day-to-day business practices" of the thousands of companies that offer their vision of The American Dream to so many aspiring franchisees.

The work of the FTC in this area has been commendable to date, and it is clear to me that having The Rule in place provides not only a consistency in the oversight provided by the FTC, but also provides a yardstick by which to measure and anticipate the consequences of actions by the franchisors themselves, a circumstance that was severely lacking in the franchise industry prior to the inception of The Rule.

Modifications can improve The Rule and are necessary, but they should be looked at for just that purpose. The Rule itself is a positive and significant benchmark for the continuing growth and expansion of the franchise industry, and I believe all of the various parties and entities involved in
franchising have a vested stake in continuing The Rule as a basic format for the industry and in improving The Rule as time goes on to make it a more viable and relevant tool for the on-going expansion and growth of this industry!

As submitted by:

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Risks: Trade shows a major source of revenue for franchisor associations, Trade show are where the greatest lies are told, F.T.C. Public Comments, United States, 1997, American Dream, Law protects franchisor not franchisee, Ban gag orders, Franchisors push for weak national franchise law, Illusion of government oversight, Cat's-paw, United States, 19971030 Comment 116