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Re: **Model Franchise Exemptions**

Gentlemen:

Our firm is pleased to provide comments to NASAA's Franchise and Business Opportunity Group with respect to its proposed Model Franchise Exemptions. These comments focus on two areas: (a) suggested broadening of the scope of one currently proposed exemption and the addition of a new exemption; and (b) suggested revisions designed to either eliminate potential ambiguities or make the exemptions more consistent with NASAA's stated objectives of reducing compliance burdens on franchisors while also assisting prospective franchisees to make an informed investment decision.

Broadening the Exemptions.

1. Fractional Franchise Exemption. The current draft of NASAA's Model Franchise Exemptions ("**Current Draft**") recommends an exemption for fractional franchises – an exemption similar to the fractional franchise exemption present in both the amended and original FTC Franchise Rule. One definitional pre-requisite, set forth at 1(a)(ii) of the Current Draft and identical to the FTC Rule language, requires that anticipated sales arising from the franchise relationship "not exceed 20% of the franchisee's total dollar volume of sales during the first year of operation." (emphasis added.) Experience with this exemption revealed that a franchise sale that otherwise satisfied the exemption's pre-requisites was, nevertheless, potentially unavailable if the purchaser chose to create a subsidiary to purchase the franchise, since the subsidiary would not itself have "non-franchise" sales. In 1999, the FTC issued Informal Staff Advisory Opinion 99-5 that stated, among other things, that: (a) creating a

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subsidiary as the franchise purchaser was a commercially reasonable and sensible action; and (b) "there was nothing inherently deceptive or abusive about establishing a franchised business as a wholly-owned subsidiary" or any reason to "elevate form over substance." The Opinion concluded that both the parent and the franchisee-subsidiary's total dollar volume of sales must be considered when calculating the franchisee's 20% dollar volume. The FTC has applied this interpretation for the past 12 years without any evidence of resulting consumer harm. We recommend that this same principle be incorporated into the Current Draft.

2. Adding an Exemption for Franchise Sales Involving Nominal Fees. We suggest that another exemption be added: the nominal fee exemption. This exemption, which has been present in both the original and amended FTC Rule as well as in the franchise registration/disclosure laws of several states, exempts franchise sales where the franchisor or its affiliates receive only a nominal amount (the FTC Rule amount is $500) during the early stages of the franchisee's operations (the FTC Rule timeframe is any time before, to within six months after, the franchisee commences business operations). The regulatory rationale for the exemption – that if a franchisor did not collect up-front monies from a franchise sale, the franchisor would have neither the incentive to engage in, nor the ability to profit from, any unlawful sales practices or non-performance of contractual obligations – has been completed validated, as measured by the paucity of enforcement activities associated with the exemption over the 32+ years that the FTC Rule has been effective. For obvious commercial reasons, this exemption is not likely to be used often; nevertheless, from our experience it occasionally has been useful when time is of the essence in closing a sale but the required franchise disclosure materials and/or required state registrations are not available.

Suggested Revisions

Section 3 (a)
Existing Franchisees

1. Subsection (i)(4) requires that the first sale be "lawful." We suggest that the word "lawful" be clarified by inserting a bright-line standard for "lawful," such as that the required pre-sale disclosure was timely made and accurate and that the franchisee has not asserted claims against the franchisor. The franchisor has no way of definitively knowing if the franchisee might later claim that the first sale was somehow unlawful for other reasons – such as the franchisor's Franchise Disclosure Document ("**FDD**") omitted or misstated required information, the franchisor failed to perform as promised, etc. In such event, and even though a franchisor might in good faith have relied on this exemption, the franchisor could then be subject to an independent claim that the second sale also was unlawful because the exemption was (retroactively) not applicable. Because of the uncertainty created by this pre-requisite, we recommend that it either be eliminated or clarified; if clarified, the franchisor should be permitted to secure and rely upon a certification from the existing franchisee - to be provided at the time of the subsequent franchise sale – that the prior sale satisfied whatever "lawful" standard is inserted into (i)(4).

2. Subsection (ii)(5) requires that the franchisor deliver a copy of its FDD to the purchaser prior to the sale. If the franchisor has a current FDD, it obviously would be prudent to do so, regardless of any legal requirement. But, in some circumstances, franchisors may not

have a current FDD. Nevertheless, for all of the groups covered by the Current Draft's exemptions, a current FDD will not materially affect the purchaser's ability to make an informed investment decision since all of these groups either are already thoroughly familiar with the franchisor or are sophisticated businesspersons who utilize the necessary professional assistance to be able to intelligently evaluate the offer. For these reasons, we recommend that this subsection be modified to read:

> "If it has a current Franchise Disclosure Document prepared under the FTC Franchise Rule or the Franchise Registration and Disclosure law of another state, it delivers a copy of such document to the prospective franchisee at least 14 days before the sale."

3. Subsection (i)(5) requires that the franchise agreement be "substantially similar" to the "first" franchise agreement signed between the parties. We have three concerns about this requirement.

- It locks the parties into an outdated agreement. Indeed, the "second," "third" or later franchise agreement may not be signed until many years after the "first" such agreement. Franchise agreements evolve over time, as they must, to accommodate business, competitive and legal changes. What benefit inures to either party and/or what public interest is served by requiring the use of a no-longer-used agreement that does not reflect these changes? If the concern is that a franchisee may not be aware of the franchise agreement changes, we think the concern is unfounded if for no other reason that subsection (ii)(5) requires receipt of the franchisor's FDD where the new agreement terms are described. However, if our recommended change to subsection (ii)(5) is accepted and the franchisee does not receive an FDD then, any such concern can be addressed by requiring the franchisor to provide, in lieu of its FDD, a marked-up copy of the franchise agreement showing the changes from the franchisee's "first" franchise agreement. Under either alternative the franchisee will know what franchise agreement changes to expect.

- The requirement that the two agreements must be "substantially similar" must be clarified. Does that term include an increase in royalties from 5% to 6%? A change in a protected territory size from three miles to two miles? A new provision concerning use of domain names or incorporating a social media policy? Clearly, the phrase is highly subjective, and must be clarified.

- The requirement compares the current franchise agreement to the "first" franchise agreement. What if the franchisee currently has more than one unit, having purchased other units after its "first" unit? Should not the comparison be to the immediately prior agreement rather than the very first one?

We would recommend that this prerequisite be eliminated entirely or at least changed to require that the franchisor provide either an FDD or a marked-up agreement highlighting the changes from the current agreement and the most recent prior agreement.

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Section 3 (c)
Sophisticated Franchisee.

1. Subsection (i)(1) requires that "each and every purchaser" satisfy minimum net worth/income criteria. We question why the scope needs to be so inclusive but, if that is the regulators' intention, then (and leaving aside any argument that, technically, the "purchaser" will very likely be a new legal entity that the investors have formed to be the franchisee), the term "purchaser" must be clarified. Does a "purchaser" refer to the equity investors? Officers? Directors? Key management? Others? If the clarified term includes individuals in addition to the equity investors, would not this requirement be counterproductive by often excluding competent executives who do not satisfy the minimum financial criteria (we note that the need for such individuals is implicit in the subsection (i)(3) reference to a "representative with sufficient knowledge...")? And how easy would it be to circumvent any expansive "purchaser" definition by simply not including any non-qualifying individual in one of the covered categories until a week after the "purchaser" buys the franchise. For these reasons, we recommend that the scope of this restriction be reduced to "any" equity investor.

2. Subsection (ii)(5) requires that the franchisor deliver a copy of its FDD to the purchaser prior to the sale. Please refer to our discussion at paragraph 2 of our comments with respect to Existing Franchisees.

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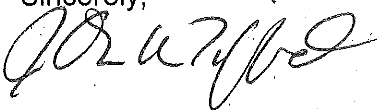
We thank you for the opportunity to offer our firm's thoughts on these important matters, and hope that our comments will be useful to you as you finalize your recommendations. Our firm very much appreciates and supports your efforts to bring more uniformity into the laws governing the sale of franchises.

Sincerely,



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