Federal Trade Commission
Office of the Secretary
Constitution Center
400 7th Street SW
5th Floor
Suite 5610 (Annex F)
Washington, D.C. 20024

Re: Franchise Rule
16 CFR Part 436
Comment, Matter No. R511003

Dear Acting Secretary Tabor:

On behalf of the International Franchise Association ("IFA") and its members, we submit these comments in response to the Federal Trade Commission's ("FTC") request for public comment on its Trade Regulation Rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising" (the "Rule"), which request was published in the Federal Register on September 10, 2020 (85 Fed. Reg. 55850).

IFA is the world's oldest and largest organization representing franchising worldwide. Celebrating 60 years of excellence, education, and advocacy, IFA works through its government relations and public policy, media relations, and educational programs to protect, enhance, and promote franchising. Through its media-awareness campaign highlighting the theme, "Franchising: Building Local Businesses, One Opportunity at a Time," IFA promotes the economic impact of more than 773,600 franchise establishments, which support nearly 8.4 million jobs and $787.5 billion of economic output for the U.S. economy.[1] IFA members include franchise companies in over 300 different business-format categories, individual franchisees, and companies that support the industry in marketing, law, and business development. IFA represents more than

[1] https://franchiseeconomy.com/assets/32302.pdf

1,300 franchisor members, thousands of their individual franchisee owners, and hundreds of product and service suppliers to the franchise community.

IFA and its multitude of members have, over the years, collaborated with public officials domestically and internationally to shape the laws and policies that govern franchising, with the goal of promoting franchise growth and protecting the critical interests of both franchisees and franchisors. As IFA's 60-year record of accomplishments amply demonstrates, IFA has consistently supported regulatory policies designed to ensure that prospective franchisees receive relevant and material information about their proposed franchise purchases sufficiently in advance of those purchases to enable them to make informed and unpressured purchase decisions. IFA also has supported a proper balance between the legitimate disclosure needs of prospective franchisees and the compliance burdens and costs—borne by both franchisors and franchisees—that such disclosure inevitably entails.

IFA actively participated in the deliberations leading to both promulgation of the Rule in 1978 and its modification in 2007, supporting the FTC's early initiatives in the disclosure area and then applauding the FTC's willingness to recalibrate the Rule's specific disclosure requirements 30 years later—based on detailed comments submitted by various stakeholders in franchising, including the IFA—to reflect numerous advancements in technology, new and emerging trends in modern-day franchising, and a shift in the information deemed relevant and material to prospective franchisees.

With FTC staff having conducted several panels on November 10, 2020, on certain aspects of the Rule and practices in modern-day franchising and having invited formal comment on those topics, IFA once again wishes to share its positions with the FTC.

Should the FTC Mandate Financial Performance Representations?

The FTC already has twice concluded—once in connection with its 1978 Statement of Basis and Purpose ("SBP") for the original 1978 Rule and again in its 2007 SBP for the amended Rule—that financial performance representations (formerly "earnings claims") ("FPRs") should be voluntary and not mandatory. In revealing its most recent conclusion, the FTC:

> recognize[d] that false or misleading financial performance claims are the most common allegation in Commission franchise law enforcement actions. However, there is no assurance that mandating performance claims will in fact reduce the level of false claims. Given that many different industries are affected by part 436, what makes a financial performance disclosure reasonable, complete, and accurate is quite varied. Thus, the Commission will not mandate a particular set of financial performance disclosures.[2]

The FTC was buoyed by the record before it, which revealed that at the time "approximately 20% or more of franchisors choose to make financial performance disclosures. Accordingly, prospective franchisees can find franchise systems that voluntarily disclosure such information. If prospective franchisees were to seek out such franchise systems, or demand the disclosure of such information from franchisors, ordinary market forces might compel an increasing number of franchisors to disclose earnings information voluntarily, without a federal government mandate."[3]

The FTC's confidence in "ordinary market forces" many years ago certainly was not misplaced and to this day supports retaining the voluntary nature of FPRs. "Ordinary market

[2] Disclosure Requirements and Prohibitions Concerning Franchising, 16 CFR Parts 436 and 437 (2007), at 15498.
[3] *Id.* at 15498.

forces" indeed have propelled franchisors to provide increasing transparency into their systems' financial performance disclosures, with 66% of all franchisors disclosing revenue information in their Item 19 in 2017.[4] Furthermore, franchisors have improved the quality of their financial disclosures and the level of transparency into unit financial performance under the Rule's current framework. Forty-seven percent (47%) of franchisors with an Item 19 disclose operating expenses, and 34% provide some measure of profitability, including operating income, net income, or earnings before income, taxes, depreciation, and amortization (EBITDA).[5] Since 2014, almost one-half of all franchisors have increased the sample basis of their reporting to include a larger portion of their franchised systems, on average representing 77% of their franchised systems.[6] It seems imprudent for the FTC to mandate a type of disclosure that is rife with complexities and complications (some of which are identified below) when that type of disclosure already has become increasingly normal in franchising—allowing prospective franchisees to comparison-shop—due to self-regulatory market practices.

This is particularly true when the rationale for not mandating FPRs in Item 19 (other than the ordinary market forces referenced above) is as valid today as it was in 1978 and again in 2007.[7] Mandating FPRs creates many potential difficult-to-solve problems, including the following:

- It is impossible to create a one-size-fits-all disclosure format for reasonableness, relevance, and reliability given the numerous, broad array of business sectors using franchising as a

[4] FRANdata 2017 Financial Performance Representation Study, April 2017, at 4.
[5] *Id*. at 4.
[6] *Id*. at 8.
[7] While the North American Securities Administrators Association ("NASAA") and/or its Franchise and Business Opportunity Project Group has occasionally issued commentary or other guidance on the preparation of FPRs for Item 19 with the objective of improving the quality, reasonableness, reliability, and relevance of financial performance information provided to prospective franchisees, *see, e.g.*, *NASAA Franchise Commentary Financial Performance Representations (2017)*, NASAA too has not issued any formal public report or recommendation in support of mandating FPRs.

method of distributing products and services and, what is more, the numerous different types of franchise systems operating within each sector.

- Requiring franchisors to present FPRs in a prescribed format—or with prescribed categories of information—not fitting their systems would be misleading to prospective franchisees and place franchisors at a competitive disadvantage.
- Many extant franchise agreements might not permit franchisors to obtain much of the franchisee-centric information needed for a detailed Item 19, or franchisees might not comply with their contractual obligation to furnish such information to their franchisors. To what lengths must franchisors go, and what expense must a franchisor incur, to obtain such information from non-responsive franchisees through audits or other means, e.g., default and termination? And, what are a franchisor's Item 19 options if, despite Herculean efforts, it cannot obtain the requisite information from a sufficient subset of franchisees?
- Mandating FPRs would impose substantial new accounting, data-collection, and review costs on all franchise systems, especially smaller systems less able to afford them.
- Non-sales information received from franchisees might not be reliable or verifiable without great cost and, even if verified, might be aberrant or irrelevant because of inconsistent franchisee bookkeeping and accounting. Preparing an Item 19 on the basis of such information—verified or not—increases the franchisor's potential liability to prospective franchisees.
- Mandating FPRs based on unreliable, inadequate, or otherwise-deficient franchisee-sourced information will increase the likelihood of franchisors prosecuting claims against franchisees under indemnification or similar theories for providing "bad" information to the franchisor, threatening to destabilize the franchisor-franchisee relationship.

- Franchisors may not be able to account adequately in an Item 19 for the multiple different types of units operating within their systems, in terms of location (free-standing or in-line), geography (city and state), market (urban or suburban), age, size, format, appearance (remodeled or not), type of operator ("mom and pop" or experienced multi-unit owner), form of franchise agreement, products, and services.
- What if the franchisor's existing units—company-owned or franchised—are not prototypical of the franchised units planned for offering or, even if prototypical, benefited from unique market or historical factors leading to atypical performance?
- The outright (but understandable) prohibition of disclaimers in Item 19 precludes franchisors from contextualizing information for their systems that does not fit the mandated format, increasing their liability risks if the franchisee's performance does not achieve disclosed levels.
- Foreign franchise systems wishing to enter the U.S. market would be forced to present financial performance information for units operating in their home countries that almost certainly would be inapposite as an indicator of potential unit performance in the U.S., exacerbating the risk of misleading disclosures.
- The number of carve-outs from and exceptions to mandatory FPRs that would be necessary to account for these myriad difficulties would accomplish little more than creating a Swiss-cheese, incoherent, and impractical mandate.
- Other sources remain for relevant financial performance information, including, for example, existing franchisees disclosed in every franchise disclosure document.
- Bad-actor franchisors that are hell-bent on violating the law by providing untrue, unreliable, and unverifiable financial performance information to prospective franchisees

> are likely to continue their mischievous ways even with an Item 19 mandate. Even if they were to prepare Item 19s, those Item 19s would likely be false and misleading in any event, and the bad-actor franchisor are likely to continue their age-old practice of furnishing false financial performance information outside the four corners of the franchise disclosure document.

The IFA respectfully submits, therefore, that the FTC should adhere to its reasoned decision in 2007 that, consistent with the original version of the Rule and the "old" UFOC Guidelines, FPRs should remain voluntary.

Should the FTC Require an "Executive Summary" of Key Information in the Franchise Disclosure Document?

Many participants in the franchise sector have suggested over the years that numerous prospective franchisees do not read the franchise disclosure documents presented to them and therefore are uninformed or ill-informed about their intended franchise acquisitions. These parties proffer that some type of "executive summary" of or similar supplement to the base franchise disclosure document would enhance the likelihood that prospective franchisees would review and understand at least some information about the franchise system in which they are considering an investment.

While the IFA favors informed investment decisions because an educated franchisee protects itself as well as the franchisor and the entire franchise system, the FTC must tread carefully before devising and implementing any such summary or supplement. A summary document may very well dissuade the prospective franchisee from reading any other portion of the franchise disclosure document and give the false impression that the summary or supplement is the only information worth reviewing to make an informed decision.

The prescribed FTC cover page to the franchise disclosure document already includes numerous admonitions and directions to the prospective franchisee to assist in its investment decision. Indeed, NASAA's new State Cover Pages implemented as of January 1, 2020,[8] already include cross-references to portions of the franchise disclosure document where the prospective franchisee can find relevant information on specific topics as well as highlight certain risks in franchising for the prospect to consider. Perhaps a more viable option for the FTC would be to adopt for the Rule the first two pages of the new State Cover Pages.

In FAQ #21 of its amended Rule FAQs, the FTC—questioning whether a franchisor could "require a prospective franchisee to list the statements in the franchisor's disclosure document that he or she regards as material to his or her decision to sign the franchise agreement"—confirmed that this practice was not allowed, opining that "a prospective franchisee is entitled to regard as material each and every statement in a franchise disclosure document." For the FTC to pick "winners" and "losers," in terms of what should be encompassed in an executive summary or supplement, runs the risk of the FTC's deciding for the prospective franchisee of the particular franchise what is or is not material to that particular prospect, to say nothing of the difficulty of determining which summary topics are most germane for all different franchise systems in multiple different business sectors.

A prime example of this difficulty relates to Item 19. If an Item 19 is the information most material to a prospective franchisee, which many claim to be the case, that financial performance information surely should be addressed in the executive summary or supplement. Yet how does one effectively summarize what is a detailed, number-intensive, and typically complex

[8] NASAA State Cover Sheets Instructions (2020).

presentation? Would a bottom-line summary of Item 19's contents exacerbate the very concerns many articulate in opposition to a summary, i.e., that the prospect will ignore the more-detailed presentation appearing in the franchise disclosure document? Perhaps NASAA's approach with its new State Cover Pages strikes the right balance. The prospect is directed where to find detailed information on various topics tending to be of particular interest to prospective franchisees. Adopting this approach in the Rule also would address the concern articulated by some that NASAA's State Cover Pages need not be used in the so-called "non-registration" states, which creates a loophole for franchisors not franchising in such states.

Should the FTC ban the use of "Franchise Compliance Questionnaires" and "Integration Clauses"?

So-called "Franchise Compliance Questionnaires"—signed by franchisees as part of and immediately before the franchise-agreement-execution process—are viewed by some suspiciously as "super disclaimers" that are used by franchisors against franchisees opportunistically during the franchise term to preclude franchisee assertion of what are otherwise bona-fide claims of franchisor wrongdoing in the franchise-sales process. The franchisee blindly signs these Questionnaires, it is argued, succumbing to franchisor pressure in the franchise sales process and never really reviewing them for accuracy.

To the contrary, these Questionnaires are fact-finding documents—not binding agreements—signed before the franchise sale is consummated, asking whether (i) the franchisee received a financial performance representation outside the four corners of the franchise disclosure document or inconsistent with the Item 19, or (ii) a franchisor representative made other promises or representations about the franchise opportunity that were inconsistent with the express

provisions of the franchise disclosure document, the franchise agreement, or other franchise-related documents.

While Questionnaires confirm facts in "real time" that prevent the franchisee from changing its story later on—typically after it has second thoughts about its earlier franchise acquisition—Questionnaires serve a more fundamental, salutary objective. They allow franchisors to determine *before* the franchisee has contractually committed to the franchise investment, and *before* the franchisor has consummated the franchise sale by counter-signing any contracts, whether there were improprieties in the franchise-sales process or inaccurate or inconsistent information provided to the prospective franchisee. Armed with that information before the franchise is granted enables the franchisor to redress possible wrongdoing *before* it commits a violation of the Rule by proceeding with the franchise transaction. The franchisor can correct any misinformation provided to the prospective franchisee—ensuring that the prospect also understands the true state of affairs—or even decide not to pursue the transaction after all if the risk is too great in order to avoid potential claims down the road. The franchisee benefits as well from the use of Questionnaires because it has one final opportunity to call out to the franchisor's attention any issues the franchisee has discerned during the franchise-sales process. The franchisor relies on the franchisee's attestations before the deal closes because, but for those attestations, the franchisor might have pursued a different path. Questionnaires therefore serve a valuable role in the franchise-sales process.

Integration clauses in franchise agreements also serve a complementary but fundamental role in this process. As with any other agreement in general contract-enforcement jurisprudence, franchisors and franchisees must be able to rely on the written franchise agreement and related contracts as the final manifestation of the terms upon which the parties intend to proceed.

Otherwise, the contract would be anything but a "contract"; it would be susceptible to unlimited and unbounded assertions by both parties that this term or that term was intended to be part of their agreement despite its absence anywhere within the four corners of the written document.

The FTC already concluded in 2007 that a limited disclaimer prohibition, rather than a total ban, was warranted. Integration clauses and waivers serve valid and valuable purposes, including ensuring that a prospective franchisee, in making its investment decision, relies solely on information authorized by the franchisor or within the franchisor's control, as reflected in the executed written document. At the same time, franchisors and franchise sellers may not use integration clauses or waivers as a shield to insulate themselves from false or deceptive statements made in a franchise disclosure document, including its exhibits. A broader prohibition would exceed what is necessary to address the underlying issue, i.e., the need to prevent deceptive disclosure documents.[9] The FTC's position remains as valid today as it did in 2007.

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The IFA hopes that the foregoing comments are helpful and expresses its appreciation for the FTC's role in preserving a Trade Regulation Rule that contributes to the well-being of an essential and vibrant segment of the United States economy.

Respectfully Submitted,

Robert Cresanti
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International Franchise Association

[9] Disclosure Requirements and Prohibitions Concerning Franchising, 16 CFR Parts 436 and 437 (2007), at 15533-36.