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Living in the Shadow of *National Survival Game*

By George J. Eydt

On Nov. 14, 1988, the Honorable Gerald E. Delaney of the N.Y. Supreme Court, Westchester County, released a decision that limited the utility of the New York Franchise Law's isolated sales exemption. His decision in *The National Survival Game of New York, Inc. v. NSG of LI Corp.* (200 *N.Y.L.J.* No. 93, p. 27; CCH Business Franchise Guide ¶ 9294, at 19,622) remains the law in New York. But did Justice Delaney get it right?

Franchise sales in the United States are regulated by both federal and state law. The federal FTC Franchise Rule requires franchisors to provide prospective franchisees with a copy of a disclosure document before taking any money or signing any agreement. Fifteen states also regulate the sale of franchises, and some of these states have both a registration requirement and their own disclosure document requirement. New York is one of these states. But the franchise statute in New York, as well as Indiana, Minnesota, and Washington, provides an exception for isolated franchise sales.

Section 684(3) of the New York Franchise Law reads as follows:

> There shall be exempted from the registration provisions of section six hundred eighty-three of this article

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Finding Bright Spots in Franchising

Observations from Industry Leaders

Much of the news in franchising has been negative for the last several years, as the "Great Recession" has taken its toll. In the last few months, the Massachusetts decision in *Coverall* and the upholding of the Iowa Supreme Court's tax nexus ruling have added to the gloom of a slow economic recovery. But things can't be all bad, all the time. As we begin 2012, *FBLA* asked leaders in franchise law to comment about the bright spots in franchising today.

AT&T Mobility

Charles G. Miller, shareholder, Bartko, Zankel, Tarrant & Miller

An important case that will have a profound impact on the franchise relationship is the U.S. Supreme Court's decision in *AT&T Mobility, LLC v. Concepcion*, __ U.S. __, 131 S.Ct. 1740, 179 L.Ed.2d 742 (2011) decided in April 2011. The Court overruled *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 113 P.3d 1100 (2005), which struck down as exculpatory and unconscionable a class action waiver provision in an arbitration clause in a consumer contract. The *Discover Bank* case was relied upon in *Independent Assn. of Mailbox Center Owners, Inc. v. Superior Court*, 133 Cal.App.4th 396 (2005), 34 Cal.Rptr.3d 659 to strike down a class action waiver in a franchise arbitration clause.

Until *Concepcion* was decided, many franchisors were starting to shy away from adding or continuing arbitration provisions in their franchise agreements. Arbitration was becoming costly to both sides, and franchisors did not want to take the risk that an arbitrator or panel of arbitrators might decide the merits of a class action. Further, arbitration provisions were increasingly being struck down as unconscionable. *AT&T v. Concepcion* has altered the landscape, and it is likely that arbitration provisions with class action waivers will again become common in franchise agreements.

Openings for Opportunistic Investors

Michael Seid, managing director, MSA Worldwide

This has been an odd economic period for franchising. Generally, franchising has historically had a somewhat counter-cyclical motion. Investors have looked

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> the offer and sale of a franchise if:
>
> (c) The transaction is pursuant to an offer directed by the franchisor to not more than two persons, other than persons specified in this subdivision, if the franchisor does not grant the franchisee the right to offer franchises to others, a commission or other remuneration is not paid directly or indirectly for soliciting a prospective franchisee in this state, and the franchisor is domiciled in this state or has filed with the department of law its consent to service of process on the form prescribed by the department.

This language has been interpreted to mean that the sale of the first franchise unit is exempt from registration if the unit was only offered to a maximum of two people (*See BMW Co., Inc. et al. v Workbench Inc. et al.* (No. 86 CIV 4200 1988 WL 45594 (S.D.N.Y. April 29, 1988); CCH Business Franchise Guide ¶ 9104, at 18,850). This isolated sales exemption is potentially useful for new U.S. franchisors or foreign franchisors that are new to the United States. It permits them to sell one franchise in New York without having to register a disclosure document with the state. However, the exemption would be even more useful if it also exempted franchisors from the New York disclosure requirement. If so, franchisors who qualified for one of the exemptions or exclusions under the FTC Franchise Rule could sell one unit in New York without pre-sale franchise regulation at both the federal and state level. Note that there is no isolated sale exemption under the FTC Franchise Rule. A different exemption or exclusion would be required.

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The obvious argument for maintaining New York's disclosure requirement is that the first franchisee should be afforded some protection from a disreputable franchisor. But New York's disclosure requirement is duplicative. As mentioned above, the federal rule also requires disclosure in every state and doesn't have an isolated sales exemption. If the FTC reasonably exempts a franchise sale from its disclosure requirements, then why shouldn't New York follow suit?

On its face, New York's isolated sales exemption only exempts a franchisor from the registration requirement. However, § 683(8) of the New York Franchise Law provides that:

> A franchise which is subject to registration under this article shall not be sold without first providing to the prospective franchisee, a copy of the offering prospectus, together with a copy of all proposed agreements relating to the sale of the franchise …

Registration triggers the need for disclosure. Therefore, it is reasonable to assume that a franchisor that is not subject to registration, by exemption or otherwise, is not required to provide a disclosure document. However, Justice Delaney didn't think so. In *National Survival Game* he clearly states, "The exemption from filing an offering prospectus does not, however, relieve a franchisor from the disclosure requirements of Article 33 of the General Business Law." He provides no support for this conclusion and does not discuss § 683(8) in his decision.

Exemption Language

What evidence is there that isolated sales exemption should apply to both the registration requirement and the disclosure requirement? The answer lies in the language of the other exemptions under the New York Franchise Law.

Section 684(2) exempts from the registration requirement the offer and sale of a franchise if: a) the franchisor has a net worth of $5

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Franchising

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million or more, and b) the franchisor files an application for exemption, and c) the franchisor makes 16 prescribed disclosures. This large-franchisor exemption contains the exact same lead-in language as the isolated sales exemption, exempting the franchisor from the registration requirement of Article 33. But applying the same reading to this language makes the disclosure requirement under § 684(2)(c) redundant. The § 684(2)(c) disclosure requirement is a subset of the broader offering prospectus disclosure requirement under § 683. If the franchisor is not exempt from the broader disclosure requirement under § 683 by virtue of § 683(8), then why does the exemption contain its own disclosure requirement?

Section 684(5) also provides an exemption from the registration requirement for the sale of a franchise by a franchisee for its own account. One of the conditions to this exemption is that the franchisee must provide the prospective purchaser with the offering prospectus of the franchisor currently registered with the New York Department of Law. This exemption has been interpreted to mean that franchisees are required to provide the disclosure document of their franchisor — not to create their own. This means that existing franchisees are exempt from both the registration and disclosure requirements in § 683, even though the exemption itself only references an exemption from the registration requirement.

Other New York Decisions

In my view, Justice Delaney got it wrong by not considering the effect of the first sentence of § 683(8). Unfortunately, other New York decisions considering the scope of the isolated sales exemption do not contradict his interpretation. In *BMW Co., Inc.*, the court in its opening sentence made a broad statement that § 684(3)(c) provides an exemption from the New York State Franchise Sales Act, but did not elaborate on the point. Instead, it dealt with whether the exemption can be applied to more than one franchise sale in New York, the court holding that the exemption does not apply to multiple franchise sales where there were no more than two offers per sale. In a more recent case, *Burger Bar Five Towns, LLC v. Burger Holdings Corp.*, 71 A.D.3d 939, 897 N.Y.S.2d 502 (2d Dept. 2010), CCH Business Franchise Law Guide 14,348, at 45,968), the appellate court stated "an exemption to the registration requirement exists for what is commonly referred to as an "isolated sales transaction." However, this court only considered a violation of the registration requirement and made no comments regarding a corresponding violation of the disclosure requirement, although from the facts it is clear that the defendant franchisor neither registered nor provided a disclosure document.

Other States

Fortunately for franchise practitioners, the situation is much clearer in the other states that have an isolated sales exemption. The Indiana Franchise Disclosure Law clearly states that § 9, which sets out both the registration and disclosure requirements, does not apply to the offer or sale of a franchise if the franchisor sells no more than one franchise in a 24-month period (Ind. Code, § 2-2.5-3). Under the Minnesota Franchise Law, it is fairly clear that the isolated sales exemption applies only to registration because the language of other Minnesota exemptions explicitly exempts the franchisor from both registration and disclosure (Minn. Stat. § 80C.03(e)). Under the Washington Franchise Investment Protection Act, it is clear that the franchisor is only exempt from registration, because providing disclosure is one of the specific conditions to the isolated sales exemption.

Although much clearer than in New York, the language and overall approach in these other states is not consistent and does not lead one to conclude that the New York Franchise Law's isolated sales exemption should necessarily be interpreted to exclude exemption from disclosure. Like Indiana, the New York legislature, based on an integrated reading of the statute, appears to have authorized exemption from both registration and disclosure.

Conclusion

It is time for the finding in *National Survival Game* to be reconsidered. The only reading of the New York Franchise Law that provides consistency among its various exemptions is that § 683(8) exempts franchisors from disclosure if they are exempt from registration, including under the isolated sales exemption.

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Bright Spots

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at moving from more passive investments into franchising during volatile periods on the street — especially when other investments were considered riskier. There certainly has been a long history of increases in franchise sales during periods of high unemployment and uncertainty about jobs. But due to [new federal] financial regulations and the general negative tone imposed on the economy by the current administration, coupled with the lack of available leverage in the home equity market, the expected trends in franchising in this recession did not occur initially.

Where are the bright spots? For investors, there are significant opportunities to consolidate unit ownership in some brands, and we are seeing an increase in mergers and acquisitions being done or under consideration. However, with the pricing of some of the recent transactions, I need to question the multiples being paid today, given the lag in same-store sales and the softness in new franchise sales. A lot seems to have been paid for anticipated improvements and brand potential — and that is always risky. The bright spot is that there is private equity money available for the right structured investments, and I expect the pricing of these deals to trend downward until the economy

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turns, which likely won't happen until the current administration leaves in, presumably, 2013. It makes for a good 2012 for the smart investors.

New Talent Brings Burst of Creative Thinking

Fredric A. Cohen, Cheng Cohen LLC

New blood and the innovation they bring: That's the silver lining in clouds hovering over franchising the past several years. Franchising has benefitted from a huge influx of tremendous talent fleeing or being evicted from other harder-hit sectors.

Like those who came before them, these new folks trend toward the creative, independent, and entrepreneurial. But more importantly for franchising, they bring new skill sets and best practices from the technology, manufacturing, services, or the financial sector jobs they left. They're conceiving applications for franchising as a method of distribution that until now remained "unthunk." They're franchising — or trying to develop ways to franchise — concepts that have never been franchised before. They're incorporating technologies in unimaginable ways to remake business methods, models, and relationships. They're forcing C-suite executives, competitors, vendors, and service providers to step up their game. These are great folks to work with and even better for franchising's future.

Sure, things are tough. But the opportunistic aren't sitting around waiting for banks to reopen the spigot. They're "dealing with it" and adapting great new ideas to the environment as-is. This is a very good time for franchising.

Private Equity Investors

David Koch, partner, Plave Koch PLC

The enthusiasm of private equity companies for franchise brands is a big positive for franchising. Many franchise acquisitions — of both franchisors and multi-unit operators — carry high multiples. This is a collective endorsement from a community of very smart people who make their living by poring over business models. It's like a movie critic's stamp of approval: It doesn't guarantee that customers (prospective franchisees) will fill the theaters (buy lots of franchises), but the expert validation encourages filmmakers to keep trying and invites others to create. Also, there is no longer a void in the small-market/middle-market space where most franchise brands reside. Deal sizes in franchising are usually too small for the big-boy private equity firms, but a whole panoply of savvy smaller private equity firms have filled the niche. Their eagerness to invest not only says that the business model works, but also that they expect franchise brands to grow.

Non-Compete Provisions

Jay W. Schlosser, partner, Briggs and Morgan, P.A.

From a franchisor perspective, one area of optimism is the continuing trend by courts and legislators to enforce post-term non-compete provisions contained in franchise agreements. In May 2011, Georgia passed a new statute that should make it easier for franchisors to enforce their post-term non-compete provisions with respect to franchisees in Georgia. Moreover, in two decisions this fall, federal courts in North Carolina and New Jersey granted preliminary injunctions enforcing post-term non-compete provisions set forth in franchise agreements. *See Meineke Car Care Centers, Inc. v. Bica*, No. 3:11-cv-369-FDW-DCK, 2011 WL 4829420 (W.D. N.C., Oct. 12, 2011) and *Otiogiakhi v. AAMCO Transmissions, Inc.*, No. 2:11-CV-04620 (DMC)(JAD), 2011 WL 825953 (D.N.J., Nov. 17, 2011).

The enforcement of post-term non-compete provisions is critical to the continued success of franchisors. A franchisee who builds up its business and establishes customer relationships by using the franchisor's name, reputation and system, and then abandons the system to go independent, can be devastating to a franchisor. Franchisors need to be secure that their non-compete provisions will be enforced and their interests and rights protected. The fact that courts and legislators have continued to recognize and enforce the protectable interests of the franchisors with respect to these types of provisions is promising.

Greater Access to Capital

Jeff Letwin, partner, Schnader Harrison Segal & Lewis LLP

One of few hopeful signs for franchisors and franchisees in the current economic climate is that Congress has recognized that small business needs more access to capital and fewer impediments to funding business. The rules regarding SBA loans have recently been relaxed in order to support small businesses and their ability to obtain funding. One of the major undertakings of the SBA in the past year has been, pursuant to requirements of the Small Business Jobs Act of 2010, to examine the revenue-based size standards of various industries to determine whether the maximums should be adjusted to allow more businesses to be considered "small businesses" for purposes of qualifying for federal government programs. According to the SBA, this will "allow more small businesses to qualify for SBA financial assistance."

Furthermore, the U.S. House recently passed amendments to the Securities Act allowing for capital to be raised through a process known as "crowd funding." Crowd funding would give entrepreneurs the ability to make Internet equity offerings of up to $5 million. The proposed bill also will allow any number of individuals to invest, with a cap at $10,000 or 10% of an individual's income, whichever comes first.

Relaxing some of these previously existing roadblocks to such financing should create a more robust franchise market and assist both franchisees and franchisors by providing easier access to capital, which, in turn, should lead to further unit development.

Higher-Quality Franchisees

Rupert Barkoff, partner, Kilpatrick Townsend & Stockton LLP

Two possibly beneficial developments. First, I believe that the quality of franchisee might have improved as a result of the downturn in the economy. The pool of prospective franchisees may have increased, as might the quality of the candidates. The problem in this scenario, however, is that the candidates will have difficulty financing a franchise

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COURT WATCH

By Charles G. Miller
and Darryl A. Hart

Under the FAA, Courts Have Duty to Determine If Any Claims Are Arbitrable

In an interesting offshoot of the Bernie Madoff scandal, the U.S. Supreme Court weighed in to leave no doubt that the Federal Arbitration Act ("FAA") required courts to order arbitration even where non-arbitrable claims remained that may result in inefficient or possibly duplicative litigation.

In *KPMG, LLP v. Robert Cocchi, et al.*, __ U.S. __, 132 S.Ct. 23, __ L.Ed.2d __(2011), Madoff investors, who had purchased partnership interests, sued the auditors of the partnerships. The partnerships had an engagement agreement with the auditing firm that required arbitration. The action was filed in state court and alleged claims for negligent misrepresentation, violation of Florida's little FTC Act, professional malpractice, and aiding and abetting a breach of fiduciary duty. The state court decided that the negligent misrepresentation and little FTC Act claims were direct in the sense that the investors were not suing the auditor derivatively for wrongs to the partnership. It thus denied the motion to compel arbitration without deciding anything about the remaining claims.

The Supreme Court, in a *per curium* opinion, reversed because, under the FAA, the state court had a duty to determine whether any of the claims were arbitrable and it could not ignore that duty as the state court did. Citing its decision in *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213 (1985), the Court emphasized that if any claim was arbitrable, the court had no discretion to refuse arbitration because other claims were not, even if "the result would be the possibly inefficient maintenance of separate proceedings in different forums." *Id.* at 217. It remanded the case to the state court so it could determine whether the remaining claims were derivative. If so, those claims must be ordered to arbitration.

The result could thus be a war on two fronts for the auditor unless the state court could be convinced to stay the litigation pending the outcome of the "derivative" cases on the grounds that they involved common facts and would result in duplicative litigation. We do not know the basis for the misrepresentation claims against the auditors, but very likely they are based on the statements in the audit opinion which would dovetail with the malpractice claims to cause the state court to issue a stay.

It should be remembered that, under some state arbitration statutes, courts are given discretion to permit the court action of non-arbitrable claims to proceed and delay the ruling on the petition to compel arbitration. *See, e.g.*, Cal. Code Civ. Proc. § 1281.2. The *KPMG* case, due to federal pre-emption of the FAA, may render these statutes ineffective unless the court is convinced that the FAA is inapplicable.

Arbitration provisions found in most franchise agreements are extremely broad, usually using phrases such as "any and all claims relating to or arising from the franchise agreement/relationship." In the typical case, then, the court will likely not find itself in the position of having non-arbitrable claims. The issue could arise in situations where the franchisee adds additional parties not related to the franchisor (*i.e.*, other than corporate officers, directors, parent or subsidiary corporations). The *KPMG* case reminds us that under the FAA, arbitration will proceed even if there are non-arbitrable claims involving the same issues. So the battle to make the litigation efficient will be fought in the state or federal court, with the predominate test likely to be whether the arbitration result would affect the pending litigation in some way.

Attempt to Circumvent a 'Most Favored Nations' Clause in Franchise Agreement Raises Issues of Fact

MSI franchises The Medicine Shoppe stores. Its parent, Cardinal Health, acquired another company called Medicap, which became a subsidiary of MSI. Later, management of both MSI and Medicap became integrated with the same staff servicing both chains.

Traditionally, MSI franchisees paid a percent of sales to MSI, and MSI provided various services to its franchisees. However, changes in the health care industry prompted MSI to change its franchising program in 2009. Under the new program, franchisees paid a flat monthly fee rather than sales-based royalties, and most of the services provided by MSI were eliminated. In an effort to convert its existing franchisees to the new program while not totally losing the benefit of its royalty income, MSI offered most existing franchisees three options: 1) convert to its new license agreement by paying a discounted amount to cover the franchisee's projected future royalties; 2) pay MSI the projected future royalties under their existing license agreement and exit the system; or 3) continue under their existing license agreement, paying the royalties and receiving the services called for in the contract.

The plaintiffs in *JMF, Inc. and WW, Inc. v. Medicine Shoppe International, Inc.*, Bus. Fran. Guide (CCH) ¶ 14,692 (Sept. 19, 2011) were The Medicine Shoppe store owners in North Dakota who had previously signed early renewal agreements in part because of a "most favored nations" clause contained in the renewal terms. Under that provision, if more beneficial terms were offered to a prospective franchisee in the state where the franchisee is operating, the existing franchisee will have the option to convert to the more favorable agreement at no cost. The language of the clause at issue in

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Court Watch

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this case stated that "[t]his conversion right shall apply only to a new form of license agreement then being offered to new franchisees seeking to become members of the Franchise Network."

Not willing to sustain the income loss that would result by allowing franchisees with agreements that contained the "most favored nations" clause to convert to the new terms at no cost, MSI withheld the offer of new The Medicine Shoppe franchises in states in which those franchisees were located.

MSI offered the plaintiffs in this case only the option to convert upon payment of discounted future royalties and not the other options described above. Seeking to avoid triggering the "most favored nations" provisions in the plaintiffs' license agreements, MSI began offering Medicap franchises, but not The Medicine Shoppe franchises, in North Dakota. However, it did file a Franchise Disclosure Document for The Medicine Shoppe franchises with the North Dakota Securities Commissioner, stating that it estimated it would open zero to one such franchise in the next fiscal year. The FDD indicated that rather than a continuing royalty, franchisees would be charged a $499.00 per month flat fee.

Upon learning of the FDD filing in North Dakota, the plaintiffs notified MSI that they elected to convert to the new franchise terms pursuant to the "most favored nations" provisions in their existing license agreements. MSI refused to allow them to do so, stating that MSI was not offering The Medicine Shoppe franchises in North Dakota. MSI stated that the FDD filing was merely a formality required by law and did not constitute an offer of the franchise described in the FDD. The plaintiffs then filed the above action for breach of contact and violation of N.D. Cent. Code § 51-19-11 which, among other things, makes it unlawful to make or cause to be made any material false statement or representation in any application or other document filed under any provision of the North Dakota Franchise Investment Law. That section also makes it unlawful to employ in connection with the offer, sale or purchase of a franchise "any device, scheme or artifice to defraud" or to "engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person."

MSI, in a motion for summary judgment, maintained that it was not offering franchises in North Dakota, and therefore, the "most favored nations" clause was not triggered. It sought to have the plaintiffs' claims under that provision, as well as various other claims made by the plaintiffs, dismissed by claiming there were no triable issues of fact, but only issues of law that the court could determine. The court held that there were fact issues and that a reasonable finder of fact could determine that the state FDD filing contained a material misstatement since the FDD indicated that MSI projected that a The Medicine Shoppe store might be opened during the next fiscal year; this contrasted with MSI's claim to its franchisees that none were intended. The court also held that it was a triable issue of fact whether the sale of Medicap franchises was a violation of the language in the "most favored nations" clauses since the Medicap franchises being sold could be deemed "members of the Franchise Network" because Medicap was a wholly owned subsidiary of MSI, as evidenced by: The Medicine Shoppe and Medicap having the same principal offices; offering similar goods and services; and both chains receiving support from MSI. It also held that a scheme to defraud or commit deceit could be found if MSI did not intend to honor its "most favored nations" agreements when they were made.

Since MSI has "most favored nations" provisions in its agreements with franchisees in 10 states, the outcome of this case could be significant. We will have to wait and see whether MSI bites the bullet and allows its franchisees with "most favored nations" provisions to convert without a fight, or whether some other outcome will occur. However, it is a good general rule that if you don't want to go in the front door, you probably can't go in the back door.

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purchase or its operation. But even here, there is a silver lining. If the franchisee does have the capital to get financing, or better yet, can provide all of it on its own, the franchisee might be better suited to survive if the franchise has no or only marginal success at the beginning. With less debt, the franchisee, who is so often undercapitalized, would have much less pressure resulting from smaller or no debt (in theory).

As a second observation, I sense that the trend to enter into mediation, whether voluntarily, by contract, or by judicial order, will continue to increase. If you compare the cost of mediation with the possible cost of litigation, the resulting ratio clearly favors mediation.

Expansion of Franchising Rules to Non-Profits

David L. Cahn, counsel,
Whiteford, Taylor & Preston LLP

The final appellate decision in *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States, Inc.* is the most positive recent development in the field of "franchise law," as it extends the scope of enterprises that need to pay attention to compliance with franchise sales and relationship laws. This development also may benefit traditional for-profit companies that are competing in the marketplace with commercially aggressive "non-profit" entities. For example, if a not-for-profit hospital organization were to recruit doctors to develop and open branded "urgent care" facilities in various communities, in competition with Doctors Express® or Patient First®, there is no reason why the not-for-profit should be exempt from the reach of the franchise laws. There is also no reason why the operator of such urgent care facilities should not receive the protections of otherwise applicable "franchise relationship" laws.

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NEWS BRIEFS

Update: Utah Subway Franchise Dispute

Last month, the U.S. District Court for the District of Utah was asked by both parties for summary judgment in a lawsuit that pits a prospective Subway franchisee against the Town Council of Springdale, UT. Izzy Poco, LLC, a prospective Subway franchisee, filed a lawsuit in June 2010 against the Springdale Town Council over the city's ordinance against formula restaurants and the apparent unwillingness of Council members and other city officials to allow Izzy Poco to modify the Subway store to meet the ordinance, as other franchised businesses have done (see *FBLA*, December 2011, page 8). Earlier, the court had granted summary judgment to remove individuals in city government who were named in the lawsuit.

On Dec. 8, 2011, both parties asked the court for a summary judgment ruling on the constitutionality of the town's ordinance and said they could submit arguments to the court in March 2012. They also asked for additional time for discovery if summary judgment is not granted.

FTC's New Business Opportunity Rule Goes Into Effect on March 1

Revisions to the FTC's Business Opportunity Rule will go into effect on March 1. The new rule completes the FTC's announced intention to distinguish the purchase of a (typically) low-investment business opportunity from an investment in a more complicated and costly franchise relationship. In 2006, the FTC announced its intention to expand the scope of businesses covered under the biz-op rule and to simultaneously streamline the disclosure requirements for those businesses. With the rules in effect, the FTC has more strongly illuminated the "bright line" that distinguishes biz-ops from franchises and dealerships.

To expand coverage, the new rule eliminates two prongs of the rule that had enabled some biz-ops to avoid regulation: a $500 initial investment and a requirement that the purchaser of the opportunity had to sell goods or services directly to third-party end users, not back to the seller of the business opportunity. When the rule was proposed in 2006, the FTC stated specifically that it also intended it to cover multi-level marketing ("MLM") businesses. However, the Commission backed off that requirement after receiving nearly 17,000 comments in opposition from businesses and individuals engaged in MLM activities.

The other major impact of the new biz-op rule is on disclosure. Namely, the rule creates a one-page disclosure document that sellers must provide to prospective buyers and prohibits a wide range of misrepresentations and fictitious business references. The new disclosure document must contain, in standardized format:

- Seller's name, business location and phone number;
- Name of sales person;
- Supporting information for any earnings claims, including the number and percentage of biz-op buyers who have reached those levels;
- Whether legal actions alleging fraud or misrepresentation have been brought against the seller, its affiliates, or its key personnel;
- Specific and detailed information about cancellation and refund policies;
- Names and contact information of all people who have purchased or joined the system in the prior three years;
- If offers are marketed in languages other than English, the disclosures must be provided in those languages, too.

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International Growth

Andrew J. Sherman, partner, and Alan J. Schaeffer, partner, Jones Day

Notwithstanding domestic challenges over the past few years, we remain optimistic and bullish regarding global growth opportunities. The reasons for this foreign expansion include a greater demand for personal services, higher levels of disposable income, a developing infrastructure, an increase in the size of the middle-class consumer base, and an increased desire for individual business ownership. Foreign franchisees are eager to have access to U.S. management best practices and lower levels of risk that are inherent in the marketing of an established franchised system.

Experienced U.S. franchisers with international franchising experience around the world will tell you that the ultimate success or failure of the program will depend on three critical things: Finding the Right Partner, Finding the Right Partner and Finding the Right Partner. Regardless of the specific legal structure selected for international expansion into a particular market, the master developer or sub-franchisor in the local market should always be philosophically and strategically viewed as your "partner." The most promising candidates for global expansion will often be those with proven financial resources who have already established a successful business in the United States or their home country. Also, there is no substitute for face-to-face negotiations between parties, regardless of whether this individual is interested in a master development agreement or a single-unit franchise.

International Franchising

Stephen Vaughan, Gray Plant Mooty

While the economic conditions in the United States continue to present challenges domestically, the outlook

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Movers & Shakers

Baker, Donelson, Bearman, Caldwell & Berkowitz, PC has added new expertise in a franchise-related field through a merger with **Litchford & Christopher**, a six-attorney firm based in Orlando, FL. "The firm represents auto manufacturers in disputes with auto dealers, as well as having a general commercial practice. They have terrific expertise in an area we've not had before. Also, we're looking to leverage their presence in central Florida, where every franchise in the world has a presence," said **Joel R. Buckberg**, of counsel to Baker Donelson and a member of this newsletter's Board of Editors.

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Bright Spots

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for U.S. franchisors is not all doom and gloom. Other countries around the world have enjoyed higher GDP growth rates, and their prosperity has translated into opportunities for U.S. franchisors to reach eager consumers worldwide.

Franchisors of all sizes have announced their emergence in foreign markets, particularly Latin America (most prominently Brazil), China, India, Southeast Asia (Indonesia, Malaysia, Thailand, and Vietnam), and the Middle East to capitalize on burgeoning economies and the demand for their products. These investments are paying dividends. In the last year, many franchisors have reported increased and double-digit operating profits abroad despite flatter domestic sales. Concepts in the quick-service restaurants, specialty foods, retail (clothing), automotive products and services, personal services (handyman, cleaning services, and care for the elderly), and youth educational industries have flourished internationally as U.S. franchisors have become more adept at identifying which franchise sectors appeal to which markets. These successes have also made the markets more accessible and increased the number of potential suitors on the ground. Independent of the U.S. economy, U.S. franchisors have reason to look to the coming years with a healthy optimism.

Global Growth

Craig R. Tractenberg, partner, Nixon Peabody LLP

Without question, great optimism exists with international growth opportunities. The reasons are obvious and are easily demonstrable. While the U.S. and the Eurozone countries are repairing their economies, other world economies are clamoring for Western brands and services. Growth in the BRIC countries (Brazil, Russia, India, and China) is driving demand for goods and services from the West, and this will continue because of population growth, increased and enhanced communication with the West, and investors and lenders that do not need to de-leverage as we have in the West. The strength of banks in countries like Canada and Turkey is funding growth and expect more trade exchange as these countries reach to enhance their cross-border market shares. Increasing globalization will have positive effects on franchising and brand growth as global recognition will be the new currency for franchising merger and acquisition.

Global growth is being aided by technological and legal enhancements intended to cater to international expansion. Intellectual property protocols, which reduce the legal work for global protection, are increasing, and more countries are taking a less parochial view of intellectual property protections in favor of recognizing the importance of having a single source of reference. Brands need to learn to grow and compete on a global scale because the momentum, investment, and financing are driving growth in this direction.

A New Sense of Realism

Rochelle (Shelley) B. Spandorf, partner, Davis Wright Tremaine LLP

I will skip over the two most popular answers, international expansion opportunities and loosening of capital markets, because I find these to be over-hyped. Foreign expansion done right is best suited for well-capitalized, seasoned concepts, but is pie-in-the-sky for newbie U.S. franchisors that have yet to hone their operations. As for capital markets loosening, my personal assessment is that conventional small-business lending remains dormant for average brands and downsized executives buying their first franchise.

What I am most optimistic about is franchising's ability to attract franchisee candidates who, from my armchair perspective, are more realistic about the risks of their franchise investment and the franchisor's responsibility for their outcome. A Nov. 26, 2011 *Los Angeles Times* article quotes a local franchisee: "I'm not naive to the fact that any business venture is a gamble … But I'm investing in myself, in something I can pass on to my kids. I can't do that in corporate America." While you'll never hear franchisors using the term "gamble" to promote their investment opportunities, having franchisees accept the descriptor is a very positive development in franchising's evolution.

I am also optimistic that franchisors are finally embracing the reality that they can't succeed if their franchisees don't succeed. Both paradigm shifts bode well for more successful franchise relationships in the future. That, in turn, should improve franchise parties' access to capital markets whenever lenders do come out from hiding.

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