

BUSINESS LAW UPDATE

A Publication of the Los Angeles County Bar Association Business & Corporations Law Section
Fall 2005

LETTER FROM THE CHAIR

The end of summer means the beginning of a new year for our Section. And, for me personally, it means the beginning of my term as the Chair of the Executive Committee of the Business & Corporations Law Section. I am honored to be succeeding the many distinguished Chairs who came before me, including our Immediate Past Chair, Steven Insel of Jeffer Mangles Butler & Marmaro LLP. I thank Steve, and his predecessors, for all they have done for the Section.

As one of my first duties as Chair, I recently had the pleasure of meeting with the officers of the Section, to discuss our plans for the year. We have a great group of officers this year. (They are listed on page 11.) Many great ideas came out of the meeting, and all of the officers are excited about implementing them over the next year.

Speaking of ideas, please know that we always welcome yours. Contact details for all of the officers can be found on our website (www.lacba.org), and we would be delighted to hear from you. So feel free to contact us with any ideas, comments or complaints you may have.

Our primary purpose is to provide CLE programs. Our Co-Program Officers, Efrat Levy and Robert Carlson, have been working over the summer to develop our calendar of programs for the year. And they have done a great job! You will find a copy of our program calendar beginning on page 8 of this newsletter.

Our largest program is our Annual Securities Regulation Seminar. This will be the 38th year of the seminar. John Hartigan of Morgan Lewis & Bockius LLP is serving as Chair of the seminar and, as always, John and his committee are planning what promises to be a

great program. I hope you will join us for this on October 28, at the Millennium Biltmore.

I also hope you enjoy this newsletter, which was kindly put together by Christopher Husa of Heller Ehrman LLP.

I'll close by thanking all of you, our loyal members, for your membership in and support of our Section.

Sincerely yours,

Gregory L. Surman
Chair, Business & Corporations Law Section

FEDERAL AND CALIFORNIA FRANCHISE REGULATION — AN ERA OF CHANGE

By David Gurnick
Lewitt, Hackman, Shapiro, Marshall &
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Introduction

We are in an era of change to federal and state regulation of offers and sales of business franchises. At the federal level, pending amendments will update the Federal Trade Commission's 27 year old regulation of offers and sales of business franchises. At the state level a bill signed by the Governor in 2004 made significant changes to California's Franchise Investment Law.

History of Franchise Regulation

The 1950s and 60s was a boom era in business franchising. Soldiers returning from wars and a growing economy provided a market for sales of business franchises.¹ The popularity of franchising led to exaggerated claims about

¹ Gurnick & Vieux, *Case History of the American Business Franchise*, 24 Okla. City U. Law Rev. 37, 47 (1999).

potential earnings, falsehoods about franchisor experience and help franchises would receive, experience or capital needed to succeed and even about celebrity involvement in the program.²

To address abuses, in 1967 the California attorney general opined that sales of franchises were sales of securities in some situations.³ Based on that opinion, the Commissioner of Corporations tried to use his Corporate Securities Law authority to regulate offers and sales of franchises. However this effort proved ineffective.⁴ In 1970 a bill was introduced to regulate offers and sales of franchises.⁵ It was signed into law by then Governor Reagan, taking effect January 1, 1971.

The California Franchise Investment Law⁶ adopted the presale registration and disclosure approach used in regulating securities offerings.⁷ The law adopted two operative requirements. A franchisor must register its offering with the Department of Corporations⁸ and must provide each prospective franchisee a prospectus disclosing specified categories of information that will be material to the recipient in deciding whether to invest in a franchise.⁹

In 1971 the FTC started an administrative proceeding to adopt a regulation on franchising.¹⁰ The FTC acted in response to complaints about conduct by franchisors. In a proceeding that lasted until 1978, the FTC found that franchises had been marketed

through unfair and deceptive practices¹¹ in a setting characterized by an imbalance of information which favored franchisors.¹² The FTC adopted a regulation, which took effect in 1979. It required franchisors to disclose information needed by franchisees to make informed decisions whether to enter into franchise relationships.¹³

Recent Federal Rule Developments

In 1995 the FTC began a review of its franchise rule and in 1997 proposed a rulemaking proceeding.¹⁴ In 1999 the FTC published a proposed revision of the franchise rule.¹⁵ In 2004 the FTC staff submitted a report with recommended changes, forming the basis of revisions the Commission is likely to adopt. The report noted that since 1979 the FTC brought more than 200 suits against more than 650 defendants for franchise rule violations.¹⁶ The staff recommended keeping the rule largely intact, while making some significant changes.

The proposed changes would add or expand circumstances in which the rule would not apply. For example, under the revisions:

- The FTC Rule will not apply to sales of franchises located outside the United States. This adopts as a regulation, a 1999 ruling of the 11th Circuit Court of Appeals.¹⁷
- A relationship is not a franchise if the only payment made by an investor constituting a franchise fee is the purchase price of goods bought for resale at their bona fide wholesale price. The changes would expand this exception by also excluding payments for leased inventory from the definition of a franchise fee.

² See, Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59614, 59628-59638 (reproduced in Bus. Franchise Guide (CCH) Par. 6302) (Dec. 21, 1978)).

³ 49 Ops. Cal. Att'y. Gen. 124 (1967).

⁴ Augustine & Hrusoff, *Franchise Regulation*, 21 *Hast. L.J.* 1347, 1351 (1970).

⁵ SB 647 (Cal. 1970).

⁶ Cal. Corps. Code Secs. 31000 to 31513.

⁷ See, *Keating v. Superior Court*, 31 Cal.3d 584, 597 (1982) rev'd on other grounds sub nom *Southland Corp. v. Keating*, 465 U.S. 1 (1984); see also *Eastwood v. Froelich*, 60 Cal. App. 3d 523, 530 (1976); *Courtney v. Waring*, 191 Cal. App. 3d 1434, 1439 (1987).

⁸ Cal. Corps. Code Sec. 31110.

⁹ Cal. Corps. Code Sec. 31119.

¹⁰ See, Statement of Basis and Purpose Bus. Franchise Guide (CCH) Par. 6301.

¹¹ See, Statement of Basis and Purpose, Bus. Franchise Guide (CCH) Par. 6312.

¹² See, Statement of Basis and Purpose, Bus. Franchise Guide (CCH) Par. 6304.

¹³ 16 C.F.R. Sec. 436.1(a).

¹⁴ 60 Fed. Reg. at 17656 (Apr. 7, 1995).

¹⁵ 64 Fed. Reg. at 57294 (Oct. 22, 1999).

¹⁶ Staff Report at n.28.

¹⁷ *Nieman v. Dryclean USA*, 178 F.3d 1126 (11th Cir. 1999).

- In an important development for oil industry franchisors, petroleum franchises (largely gasoline service stations) will be exempt from the FTC Rule because they are covered by separate legislation, the federal Petroleum Marketing Practices Act.¹⁸
- The changes will exclude from the rule's coverage, any franchises where the franchisee's estimated investment is \$1 million or more, other than franchisor financing or real estate. The premise is that franchisees who make an investment this large are sophisticated and do not need the rule's protection.
- For the same reason, franchises sold to a franchisee who has been in the business at least five years and has a net worth of \$5 million would also be exempt.
- Franchises granted to a franchisee where a 50% or more owner was either a manager or 25% owner of the franchisor, are also excluded.

The proposed rule changes adopt the Uniform Franchise Offering Circular ("UFOC") as the only permissible format for the offering prospectus. This will align the FTC Rule with the common practice of franchisors nationwide. A second disclosure format that is currently permitted but largely ignored, will no longer be available to use.

The proposed rule also makes changes to disclosures in the UFOC. Among these are expanded disclosures about litigation of the franchisor and its affiliates and disclosure about suppliers that officers of the franchisor own any interest in.

The rule changes also permit disclosures to be made electronically, rather than requiring only paper disclosures. As a condition to electronic disclosures, the prospective franchisee must have the ability to receive and store the disclosure electronically.

State Law Developments

While changes are pending at the federal level, a law that took effect January 1, 2005 made substantive revisions to California's Franchise Investment Law.¹⁹ The Bill did the following:

- Directed the Department of Corporations to review franchise registration applications based on items posing the most risk to potential franchisees, with emphasis on risks of a franchisor's financial condition, past compliance and significant deficiencies in the application.²⁰
- Directed the Department of Corporations, in reviewing franchise filings, to focus on preventing misappropriation, mismanagement, and misrepresentation in offers or sales of franchises.
- Revised conditions for exemptions for sales of franchises to pre-existing franchisees.
- Increased fines for franchise law violations.
- Added a new exemption for the offer and sale of a franchise where the buyer is an officer of the franchisor.²¹
- Added a new exemption where the franchisee is an entity with assets over \$5 million.²² The financial statement must be dated within 90 days of signing the franchise agreement or the franchisor's receipt of any consideration and cannot have been prepared just for purposes of buying the franchise.
- Added a new exemption for the sale of a franchise to any natural person whose net worth exceeds \$1 million excluding the person's home, retirement monies, home furnishings and cars.

¹⁸ 15 U.S.C. Secs. 2801 – 2806.

¹⁹ AB 2921.

²⁰ Cal. Corps. Code Sec. 31001.1.

²¹ Cal. Corps. Code Sec. 31109.

²² Cal. Corps. Code Sec. 31109.

- Added a new exemption for the sale of a franchise to a natural person whose gross income exceeds \$300,000 in each of the two most recent years (or exceeded \$500,000 together with the person's spouse), and who expects to maintain the same income level.
- Added an exemption for the sale of a franchise to an entity in which all equity owners are persons or entities that satisfy any of the above four new exemption categories.

In each instance, purchasers must have sufficient knowledge and experience to be able to protect themselves; they must buy for their own account in order to conduct the business, not to resell the franchise; and the immediate cash payment required of a natural person cannot exceed 10% of his or her net worth (or joint worth with his or her spouse). Also, in each instance, a notice and filing fee must be provided to the Department of Corporations.

The new law permits selling a franchise that differs from the contents of the disclosure in some circumstances.²³ The initial offer must have been registered. The prospective franchisee must receive an appendix to the offering circular containing a summary of each material negotiated term that the franchisor negotiated in the prior 12 months; a statement indicating that copies of negotiated terms are available on written request; and the name, phone number, and address of the franchisor representative to whom requests for a copy of the negotiated terms may be obtained.

The franchisor must certify in the renewal application that it complied with the above requirements. The negotiated terms must, overall, benefit the franchisee. The franchisor must provide a copy of the negotiated terms to the prospective franchisee within five business days following the request of the franchisee. There is also a 5-year record-keeping requirement.

Conclusion

Franchise laws have evolved over time. The changes discussed above will make the FTC Rule and state law more effective in light of experience with the existing franchise law.

²³ Cal. Corps. Code Sec. 31109.1.