Farrell Fritz, P.C.

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Focus on Franchising

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Welcome!

Welcome to our fifth edition of Focus on Franchising. Fall has arrived, and with it comes the long-awaited Staff Report on proposed modifications to the FTC Rule. This is creating considerable buzz in the franchise community and, as our lead article reports, spells out many new regulations and procedures that will affect every franchisor. As always, your comments and suggestions for future articles are welcome. Please contact us at franchise@farrellfritz.com.

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Inside

Five Years and 400 Pages Later. . . FTC Proposes Numerous Rule Changes Regarding Franchise Sales

By Harold L. Kestenbaum, Esq.

As many of you will recall, the process of revising the FTC Rule on Franchising began 10 years ago! Since then, the FTC published an Advance Notification of Proposed Rulemaking in 1997 and a Notice of Proposed Rulemaking ("NPR") in 1999. Now, as the five-year anniversary of the NPR nears, the FTC has released a Staff Report that proposes numerous revisions to the Rule, most of which will impact every franchisor. The report is over 400 pages and can be found on the FTC's website at www.ftc.gov/opa/2004/08/franchiserule.htm. Here are a few highlights of what lies ahead:

New Disclosure Documents

To start, the FTC Rule will cover only the sale of franchises. A separate rule is forthcoming that deals exclusively with business opportunities. There will no longer be an FTC disclosure document, which some franchisors currently use. The new Franchise Disclosure Document will be almost identical to the current UFOC document used in most registration states. There will still be no federal pre-exemption; if the state law disclosures are more extensive, they will govern. Also, the NPR makes it clear that the FTC Rule does not apply to international franchise transactions. This is something we have basically known for the last few years.

New Earnings Claims Rules

Item 19, "Earnings Claims," will have a new title, "Financial Performance Representations," and will no longer include costs or expenses. This means that giving out this information will not be considered an earnings claim. Item 20 disclosures will be re-tooled and made more accurate.

Electronic Disclosure Permitted

The FTC will permit electronic disclosure, provided certain requirements are met. These include: (1) the disclosure document must be in a format that can be stored, downloaded, printed or otherwise maintained for future reference; (2) before disclosing, you must advise the prospect of the formats that document is available in and any conditions necessary for obtaining or reviewing the document in a particular format; (3) all non-essential features, such as multimedia, audio, video, animation or pop-up screens are prohibited; (4) electronic versions may be furnished by email, disk or CD-Rom or by Internet access; and (5) you must retain a hard copy of the signed receipt page for three years.

10-Day Rule Eliminated

The NPR does away with the 10 business day rule and first personal meeting standard, requiring at least 14 calendar days before the prospect signs a binding agreement or makes any payments to the franchisor. The NPR proposes to eliminate the five business day rule as well.

Those are some of the basic proposed changes; however, until the registration states adopt these changes, franchisors may be faced with the prospect of disseminating two different versions of the disclosure document. Not a very welcome thought.

By James M. Wicks, Esq.

Who's Your Applicant Anyway?

Think you know who your applicants are? Better check! Cici Enterprises, Inc., a pizza restaurant franchise, thought it knew who was submitting a particular application . . . until not one, but three individuals later brought an action against Cici for fraud and unlawful discrimination.

Although only one of the three plaintiffs actually completed the application, indicating that she was the "sole applicant" for the franchise, the two others assisted in the process and had requested information from Cici regarding the process and criteria for obtaining a franchise. The two others also claimed to have received counsel and advice from Cici's Director of Franchise Sales as to how to buy a franchise. When Cici denied the application, the three individuals sued, claiming that the company committed fraud in the application process and that it engaged in unlawful discrimination in violation of the Civil Rights Act.

After Cici successfully had the case transferred from Oklahoma federal court to Texas federal court, Cici argued to the Texas court that the two individuals lacked standing to bring the action since they were not "applicants." The court disagreed, however, finding that the three individuals could prove, based upon their allegations, that they are entitled to relief as "joint-applicants." The court relied heavily upon the fact that the two non-applicants requested information from Cici, and that the Director of Franchise Sales assisted and counseled them. Furthermore, the two had sent a "confidential personal profile" to Cici, which is the first step in the application process. As a result, the court allowed the lawsuit to proceed by all three against Cici, on the fraud and discrimination theories.

The lesson learned? Make sure you have clear guidelines as to when someone becomes

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Seeking Aggressive Growth? Consider Re-Franchising Company-Operated Units

By Gene Cerrotti

Re-franchising - the sale of company-operated units to franchisees - has become a highly effective strategy for driving aggressive growth, re-imaging and revitalizing a brand. Here are the main benefits to the franchisor:

Attracting Aggressive Quality Developers

Larger multi-unit operators are always looking to diversify through potential acquisitions. An acquisition in a new franchise concept gives them immediate cash flow to run a new division, as well as a base to develop additional units, usually in the same or adjacent geographic area.

A franchisor selling certain company-operated units to a new franchisee will command a commitment to develop additional units; typically, two to three times as many as sold. If re-imaging is required, this will also be achieved.

As an example, if you re-franchise five packages of four units each, each new franchisee will commit to develop eight to 12 units over the next five years. A development schedule of about two units per year is reasonable. The 20 units sold will have now been leveraged to an additional 40 to 60 units over a five-year period. Plus, of course, you have attracted five experienced and well-funded multi-unit franchisees to your system!

Generating Cash

As a result of the transaction, cash has been generated from the sale of the units, which can be used to pay down debt, fund additional units or simply increase cash reserves. In addition, a royalty stream is now being generated not only from the units sold, but also from the newly-developed units as they come online.

Attracting Multiple Lenders To Your Concept

Top franchise lenders like to finance acquisitions because they can see historical results and sales trends, determine real estate values, and gain a good understanding of the concept's overall performance.

The sale of a multi-unit package can be an entree to lenders for the franchisor. It can generate sufficient interest in the franchise concept to make it worthwhile for the lender to spend the time and money to approve the concept. Once approved, this will pave the way for lenders to provide financing for other new and existing franchisees.

For franchisors who grow primarily through single-unit development, SBA lenders have been the primary source of financing support. The sale of multiple-unit packages to larger franchisees will attract portfolio lenders. Because of SBA loan size limits, a portfolio lender is a critical addition for

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multiple-unit development and aggressive growth. Having existing multiple-unit franchisees will encourage other multiple-unit operators to join your system.

If a system does not have a reasonable mix of single-unit and multiple franchisees, this may give prospective new multiple-unit operators reason to pause. Re-franchising gets your concept past this hurdle quickly.

Bottom line, re-franchising has proven to be a very effective means of growth for franchisors by accelerating re-imaging, enhancing relationships with lenders, and attracting experienced and well-financed multiple unit operators.

Gene Cerrotti is CEO of Praetorian Group, a franchise consulting company specializing in mergers and acquisitions. He can be reached at genec@praetoriangroup.net.

LITIGATION NOTES

Are You Obligated To Produce Franchisee Business Records in Litigation?

By Eric W. Penzer, Esq.

You're a franchisor mired in litigation with a vendor. You are told by your lawyers that you are in the "discovery phase," which you view more as a "fishing expedition." Your lawyer sends you the first set of document requests served by the vendor. The vendor is demanding that you produce the business records of one of your franchisees. You quickly advise your attorney that you "don't have those records, the franchisee has them." Have you satisfied your discovery obligations? Maybe not.

The Federal Rules of Civil Procedure - applicable in all federal civil actions - impose specific discovery obligations upon the parties to a litigation. Specifically, a party is required to produce requested documents if they are within that party's "possession, custody or control." The rules also require parties to make initial disclosures - without a demand therefore - of "all documents, data compilations, and tangible things that are in the possession, custody, or control of the party and that the disclosing party may use to support its claim or defenses, unless solely for impeachment." In construing these rules, the courts have rejected a narrow physical-possession test, focusing instead on whether the party has a legal right to custody or control of the documents in question.

Assuming that a franchisee generates and maintains business records that are not within the franchisor's possession or custody, is it possible that such records may still be deemed to be within the franchisor's "control" for discovery purposes? In a litigation between the franchisor and a third-party - i.e., a litigation to which the franchisee is not a party - is the franchisor required to obtain and permit discovery of its franchisees' business records?

Although research has disclosed no published caselaw authority squarely addressing the issue, by applying well-established general principles, a compelling argument can be made to impose such a duty. In a federal case emanating from the Southern District of New York, the court explained that "[p]ossession by an attorney or a third party of the document or matter required to be produced cannot be used as a means of avoiding compliance with a direction for its production. The true test is control and not possession." Control has been defined by various federal courts to mean "not only possession, but [also] a legal right to obtain the documents requested upon demand." Generally speaking, if the party responding to a discovery request has the right to secure documents in the possession or custody of another person or entity in the ordinary course of business, the courts will not permit the party to deny "control" of such documents for purposes of discovery by an opposing party.

Applying these legal principles, a franchisor may well be in "control" of documents - including electronic data - in the possession or custody of its franchisees. Inasmuch as most franchise agreements permit the franchisor to inspect and demand documents and records maintained by the franchisee, the franchisor certainly has the legal right to obtain the documents requested upon demand. Thus, under the general legal principals enunciated above, the franchisee's documents may well be within the "control" - for discovery purposes - of the franchisor.

Moreover, the process of defining the universe of documents within a litigant's "control" must commence as soon as a dispute arises, even if litigation has not yet ensued. The reason for this is that several federal courts have stated that once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a "litigation hold" to ensure the preservation of relevant documents. This includes

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an "applicant" in the process. Take care in all communication with prospective applicants - both written and oral - to ensure that they are not considered "applicants" unless and until they complete the process. Make sure to create and maintain a clear paper trail to that effect with all applicants. The bottom line is: be clear, be consistent and follow your procedures carefully as you consider prospective applicants. Otherwise, you may very well risk being hauled into court by someone you never even contemplated could do so.

Farrell Fritz Briefs

Lyle C. Mahler, an Associate in the Corporate and Banking Department, has joined our Franchise & Distribution Practice Group.

Our firm is also pleased to welcome Cathleen A. Coyle, Conall C. Flanagan and Joseph T. LaFerlita as Associates.

Events Calendar

November 5
Farrell Fritz Franchise Forum in Tampa, Florida.To reserve a place, contact Harold Kestenbaum: phone, 516-227-0642; email, hkestenbaum@farrellfritz.com

December 3
Farrell Fritz Quarterly Franchise Forum. To reserve a place, contact Helen Rajcooar: phone, 516-227-0641; email, hrajcooar@farrellfritz.com

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LITIGATION NOTES (Continued from page 3)

electronic data, i.e., e-mails, computer files, back-up tapes, etc. The courts have become increasingly willing to impose severe sanctions upon a party if relevant documents - including electronic data - are destroyed, advertently or inadvertently, after a dispute arises.

Accordingly, attorneys and their clients must be aware of their respective discovery obligations. The cases make clear that parties must be prepared for the discovery process *before* a dispute arises, and must pay detailed attention to discovery obligations immediately *after* a dispute arises.