

FEDERAL TRADE COMMISSION

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In the Matter of:)
Franchise Rule)
) File No. R511003
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Monday, October 20, 1997

Suite 2150
Federal Trade Commission
19999 Bryan Street
Dallas, Texas

The above-entitled matter came on for testimony pursuant to notice, at 9:20 a.m.

APPEARANCES:

ON BEHALF OF THE FEDERAL TRADE COMMISSION :

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Federal Trade Commission
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1 ALSO PRESENT :

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P R O C E E D I N G S

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MR. TOPOROFF: Good morning. We are meeting here today in Dallas, Texas, and it's October 20, 1997. And this is the fourth of six public workshop conferences to discuss the Commission's Advanced Notice of Proposed Rulemaking. Today we are going to discuss the sale of business opportunities.

My name is Steven Toporoff. I'm in the Division of Marketing Practices at the Federal Trade Commission, and I'm going to conduct the meeting today.

This meeting is open to the public. It is being recorded, and a transcript will be made available and put on the public record. We are also going to post an electronic copy of the transcript on the Internet at our web site.

Today's meeting is going to be less formal than other public workshops that we've had, and we're not going to follow any strict agenda, nor will this be a round-table discussion. But we are making this opportunity for members of the public or other interested parties to come in and discuss with us whatever issues they have concerning business opportunities.

I also want to add that we're going to meet again tomorrow, for anyone who's interested. The purpose of tomorrow's meeting is different than today's. Tomorrow's meeting is open for members of the public and interested parties to submit statements on the record about any issue

1 involving franchising business opportunities or the
2 Commission's Advanced Notice of Proposed Rulemaking.

3 So with that, I'm going to ask our first speaker to
4 identify himself, please.

5 MR. SNOW: My name is J.H. Snow. I'm with the law firm
6 of Jenkins & Gilchrist in Dallas, Texas.

7 MR. TOPOROFF: Okay. And just for my benefit, could you
8 give a little bit of background about the type of legal work
9 that you do as far as franchises business opportunities might
10 be concerned.

11 MR. SNOW: Our firm is engaged in representing
12 franchisors and franchisees, both product and business format
13 franchises, throughout the United States. Members of our
14 group have been involved in this practice collectively for
15 probably in excess of 50 years.

16 I, individually, have been involved in this practice for
17 approximately 15 years.

18 MR. TOPOROFF: So how many franchise clients would you
19 say that your firm represents?

20 MR. SNOW: I would estimate that at any given time, we
21 probably represent between 30 and 50 franchise clients.

22 MR. TOPOROFF: Okay. And any business opportunity
23 clients?

24 MR. SNOW: We have consulted with clients who are seeking
25 to understand the extent to which federal and state

1 regulations may regulate their business, and in some instances
2 some of those clients have been involved in a business which
3 could conceivable be construed as a business opportunity or
4 are contemplating being involved in a business of that nature.
5 And we've been able to give them advice regarding the
6 application or non-application of the FTC rule and the other
7 state business opportunity statutes.

8 MR. TOPOROFF: So as a general matter, does your firm
9 ever draft business opportunity disclosure documents or is
10 involved in any of the registration processes on the state
11 level, or that's just not something that you do.

12 MR. SNOW: We have not prepared a disclosure document
13 specifically for a business opportunity. We have certainly
14 handled the filing of exemptions among the various states that
15 offer those exemptions from the application of their state
16 business opportunity statutes.

17 MR. TOPOROFF: Okay. What are your main concerns that
18 bring you here today?

19 MR. SNOW: I think first and foremost, we want to
20 reaffirm a position that I think the Commission has already
21 reached, and that is that the kinds of businesses that fall
22 within the scope of a traditional business opportunity and
23 those which fall within the scope of a traditional business
24 format or product franchise are distinctive enough that there
25 should be distinctive disclosure obligations between the two.

1 Our sense of it, though we don't have extensive
2 representation of business opportunity sellers, is that the
3 disclosure that is warranted for that kind of business format
4 or approach to the market should be less burdensome than the
5 disclosure currently required under the rule.

6 With regard specifically to the suggested definition of a
7 business opportunity that has been published by the FTC, we
8 have a couple of concerns with that proposed definition.
9 First, we think it would be warranted to have an express
10 exclusion for franchises that are being sold in compliance
11 with the FTC rule with the disclosures that are required; and,
12 secondly, that careful consideration should be given to the
13 scope of that proposed definition and whether or not it ends
14 up including traditional product distribution arrangements
15 which are not really intended to be regulated and don't pose
16 the kinds of public policy concerns or considerations that
17 warrant regulation.

18 I think, in particular, the second part of the definition
19 that was proposed that reads, "More than nominal assistance to
20 any person or entity in connection with or incident to the
21 establishment, maintenance or operation of a new business or
22 the entry by existing business into a new line or type of
23 business" -- poses some problems in terms of vagueness as to
24 what is the scope of nominal assistance.

25 I think it is not difficult to conceive of a number of

1 fairly traditional product distribution arrangements where the
2 right is being granted to sell or distribute goods or
3 services, which is the first part of the proposed definition,
4 and involve what would oftentimes be considered at least
5 nominal assistance to the party granted that right. As such,
6 while we're not prepared to offer a proposed substitute
7 definition, we certainly believe that consideration should be
8 given to incorporating language in that definition which would
9 include those kinds of distribution arrangements.

10 MR. TOPOROFF: Okay. As far as the disclosures
11 themselves go, would you have any advice for us, which
12 disclosures we should keep, for example, or which ones we
13 should eliminate as far as business opportunities are
14 concerned?

15 MR. SNOW: I think it's difficult for us to make a
16 recommendation in that regard, given that the kinds of
17 businesses that are offering business opportunities today are
18 not ones that we have had extensive experience in
19 representing. The -- our impression is that the concerns that
20 have arisen in the past, at least, are that fraudulent
21 misrepresentations are sometimes being made with regard to
22 earnings potential and that kind of thing. And we wonder
23 whether perhaps a provision which is essentially an anti-fraud
24 provision and one which requires a minimum cooling-off period
25 would not significantly address some of the kinds of concerns

1 that have arisen in the past. But we're not prepared at this
2 time to offer specific disclosure recommendations.

3 MR. TOPOROFF: On the issue of separating the rule into a
4 franchise rule and a distinct business opportunity rule, do
5 you have any opinion on whether there literally should be two
6 separate rules, or would one rule with two different parts
7 suffice? Is there a difference between those that would
8 really make a functional difference?

9 MR. SNOW: I'm not sure that that difference would be one
10 that would be material in our opinion. The main concern is to
11 separate the concept of business opportunity from franchise,
12 not refer to business opportunities as franchises, given the
13 distinction in the approach to the market that they each
14 represent. So whether they're both -- the obligation to make
15 disclosure, presale disclosures, is contained in one rule with
16 those distinctions drawn, or whether they're two separate
17 rules, I don't think is likely to be material.

18 MR. TOPOROFF: Is there anything else that you would like
19 to add?

20 MR. SNOW: I think that probably covers it.

21 MR. TOPOROFF: Okay. Thank you.

22 MR. SNOW: Thank you.

23 MR. TOPOROFF: Let me go off the record.

24 **(Whereupon, a short recess was taken.)**

25 MR. TOPOROFF: Okay. We're going to continue with our

1 next speaker. Could you please identify yourself?

2 MS. TIDD: My name is Kat Tidd. I am an attorney in solo
3 practice. My practice emphasizes franchise business and
4 distribution law.

5 MR. TOPOROFF: Okay. Just for my background and to make
6 the record clear, could you explain whether you do any work
7 specifically with business opportunities or people that may be
8 considering purchasing a business opportunity?

9 MS. TIDD: I counsel entrepreneurs and startup companies
10 with regards to the legalities, the legal impact of the
11 proposed format of distribution they anticipate starting. It
12 often falls within the definition of a business opportunity
13 and/or a franchise.

14 I also counsel individuals who are considering purchasing
15 franchise or business opportunities -- usually, they're
16 looking at both -- and those who have purchased what turn out
17 to be business opportunities that are failed business
18 concepts.

19 MR. TOPOROFF: Okay. What are your main concerns that
20 bring you here today?

21 MS. TIDD: My main concerns with regard to business
22 opportunities involve the high level of noncompliance with any
23 disclosure. There seems to be a pattern. I would divide it
24 into two types of nondisclosure: the intentional and the
25 inadvertent.

1 The inadvertent is typically because the entrepreneur or
2 small business -- and these are usually small businesses --
3 are unaware that their form of product or service
4 distribution -- and it's primarily involving a product -- is
5 so -- is as extensively regulated as it is technically under
6 the FTC franchise business opportunity rule.

7 MR. TOPOROFF: And you also mentioned intentional
8 violations.

9 MS. TIDD: Intentional violations -- I have on several
10 occasions within the last two years had individuals come to me
11 who have purchased business opportunities that clearly
12 mandated disclosure -- compliance with the disclosure
13 requirements, both state and federal, and no attempt was made
14 to do so.

15 And in two instances that come to mind, two different,
16 quite different types of businesses, they were provided one or
17 two pieces of paper, claiming that this was a disclosure
18 statement complying with business opportunities laws. It had
19 absolutely no resemblance to either typical state requirements
20 nor the FTC rule.

21 MR. TOPOROFF: As a general proposition, do you think
22 that a disclosure system or disclosure regime works for the
23 sale of business opportunities?

24 MS. TIDD: I have to say, I'm not convinced it does. I
25 believe that certain fundamental information should be

1 required, but there is sufficient regulation, in my view.
2 Enforcement is a serious problem. Even in instances of
3 blatant violations, businesses continue to operate for long
4 periods of time once the violations have been brought to the
5 notice of the proper authorities.

6 MR. TOPOROFF: Let me ask if you have an opinion on the
7 following. One of the proposals that some people have
8 offered -- and this was discussed in our previous business
9 opportunity meeting in Chicago -- is as an alternative to
10 disclosure, whether business opportunity sellers could offer,
11 let's say, rescission. So it would work something along the
12 following lines: Either you disclose, and whatever the
13 disclosure document would look like; or in lieu of formal
14 disclosure, you would have to have a rescission offer as part
15 and parcel of the contract.

16 So if a business opportunity purchaser was interested in
17 a particular opportunity, they could get disclosures; or in
18 the alternative, at least know as part of their contract that
19 within a certain stated period of time -- let's say 30 days or
20 three months or whatever -- they could rescind if this doesn't
21 work out.

22 Would that be something that would be beneficial to both
23 business opportunity sellers, as well as business opportunity
24 purchasers?

25 MS. TIDD: Again, I would go back to the principal

1 problem, which is enforcement. Those that are intentional,
2 that's a -- set that aside, because they will simply
3 stonewall. And how are you going to go after them when the
4 cost of the investment is as typically minimal as it is in a
5 business opportunity, people aren't going to spend more money
6 chasing what they've lost. This is a key problem, because, I
7 mean, 25,000 total for a loss is pretty high for a business
8 opportunity, a number of them.

9 For those that are inadvertent, it could work. I believe
10 that would relative to the size of the investment, again, and
11 the financial strength of the offeror. Often these small
12 entrepreneurs who come up with business opportunity ideas are
13 bootstrapping their way into business using a -- the less
14 formal business opportunity format. So they are not
15 necessarily well funded. That could be a problem.

16 MR. TOPOROFF: Do you have any advice for us on how to
17 define a business opportunity, in terms of the disclosure law?
18 What should we be covering?

19 MS. TIDD: I almost feel that it has to be along economic
20 lines, relative to the size of the investment, rather than the
21 label that's put on it. It seems to me, the franchise rule
22 often has a chilling effect on the small entrepreneur with a
23 small business idea that falls within the definition of the
24 FTC franchise rule, and will go through a number of
25 contortions trying to restructure their business plan to avoid

1 compliance.

2 It is unduly burdensome and, I believe, significantly
3 hampers the creativity and a lot of the value that the small
4 entrepreneur can contribute.

5 MR. TOPOROFF: So you said that -- excuse me. Can we go
6 off the record a second.

7 **(Whereupon, a short recess was taken.)**

8 MR. TOPOROFF: We're back on the record.

9 You mentioned before about having some kind of tiered
10 disclosure regime based upon the economics. Could you flesh
11 that out a little bit, just so I have a better sense of -- I
12 don't mean for you to come up with a specific proposal, but --

13 MS. TIDD: I do not have a specific proposal.

14 MR. TOPOROFF: Okay. But just in concept.

15 MS. TIDD: It is something that has been developing over
16 particularly the last couple of years, because I do believe in
17 the need for some form of disclosure. I would say the
18 fundamental keys to disclosure at any level start with who
19 owns the business, who manages the business, the financial
20 strength of the company involved. Those are key factors.
21 Obviously, litigation history would be relevant to that,
22 bankruptcy. Those are elements that I believe are fundamental
23 to any disclosure.

24 Beyond that, what's appropriate, seriously, under an
25 investment of 5,000, I think it should be minimal with that

1 basic base. Over that, I think you're looking at a sliding
2 scale, perhaps relative to the difficulty in recovery.

3 If you -- since rescission has been proposed, if
4 rescission is for \$5,000 and they don't want to pay, how is an
5 individual who purchased a business opportunity that is based
6 in Florida going to collect? They're not.

7 MR. TOPOROFF: That's a valid point. What about the list
8 that we currently required of names and addresses or current
9 purchasers. Is that an item that the Commission should
10 retain? Is that valuable?

11 MS. TIDD: Absolutely.

12 MR. TOPOROFF: Okay. And audited financial statements,
13 is that -- how does that fit into the picture?

14 MS. TIDD: I think that's -- for many of the smaller
15 entrepreneurs, that's extremely burdensome, I do believe, in
16 the three-year staged requirement.

17 MR. TOPOROFF: Are there any other disclosures that the
18 Commission should consider either retaining, or are there
19 disclosures that currently aren't in the rule for business
20 opportunities that perhaps should be there? Any thoughts on
21 that?

22 MS. TIDD: I'm afraid not at this time.

23 MR. TOPOROFF: Okay. Finally, have you considered
24 whether the Commission should think about expanding the types
25 of exemptions that we currently have for business

1 opportunities?

2 MS. TIDD: How you would -- I believe that that could
3 work, but that's more form over substance, in my view,
4 addressing the underlying principle of what should be covered
5 and on what basis. To me, it doesn't matter how you get
6 there.

7 MR. TOPOROFF: Well, one of the concerns that the
8 Commission has, and it's something that you touched on, the
9 costs involved -- and obviously to the extent that there are
10 legitimate business opportunities out there where people
11 aren't getting scams and people are getting the services and
12 products and support that they expect, the Commission would
13 want to make sure that at least for those companies, that they
14 are not burdened with a -- with expenses involved in creating
15 a disclosure document, and especially if our law enforcement
16 history over the past 20 years or so leads us to conclude that
17 at least in certain spheres, there just aren't the types of
18 fraud and other kind of deceptive practices that we might see
19 with the sale of maybe some other types of business
20 opportunities -- that certainly through the use of exemptions,
21 appropriate exemptions, we might narrow down the rules so that
22 ultimately the rule addresses where the problems are.

23 So one of the issues that we're wrestling with are -- is
24 the appropriate exemptions here to ensure that the rule covers
25 those that we really -- where there's a real problem --

1 MS. TIDD: Right.

2 MR. TOPOROFF: -- and at the same time, those where the
3 Commission isn't aware of any particular problem, let them out
4 of the rule.

5 MS. TIDD: I would have to say that my experience
6 involving business opportunities is so sporadic, I have not
7 seen enough where I could really respond fairly to that.

8 MR. TOPOROFF: Okay. Anything else you'd like to add
9 today?

10 MS. TIDD: I would simply like to emphasize that I do
11 believe in a fundamental disclosure of those key elements I
12 referred to earlier. It is particularly key to know about the
13 individuals who are involved in the business and their
14 history, as well as some basic financial information. It is
15 truly critical to assessing the genuineness of the business
16 and its track record.

17 MR. TOPOROFF: I have one more question. Let me ask if
18 you have any opinion on the following: One of the proposals
19 that has come to our attention and that we're giving thought
20 to is focusing the triggering mechanism, when disclosures have
21 to be made, by limiting it to just 14 days, or some other time
22 frame, before the purchase is consummated.

23 Basically, what we would be doing is getting rid of the
24 earlier trigger, the first face-to-face meeting. But some
25 people have argued that at least in the business opportunity

1 context, there really isn't any prolonged negotiation. These
2 are much more packaged deals, more off-the-shelf, if you will.
3 So to have the distinction between face-to-face and 14
4 business days is really artificial, that most of the time,
5 people who are interested in a business opportunity see it,
6 speak about it, and then decide that they want to buy it.

7 So do you see any downside if the Commission were to get
8 rid of, let's say, the face-to-face prong and just focus on
9 giving the purchasers 14 days, or some other time frame, in
10 which to review the offer?

11 MS. TIDD: I actually think that that sounds like a fair
12 proposal with a reasonable cooling-off period. Things are
13 done across country, when's face-to-face -- mandating the time
14 frame to review the information and think about it outside of
15 the personal contact is what's really important, not the face-
16 to-face meeting. So I would certainly agree with something
17 along those lines.

18 MR. TOPOROFF: Okay. All right. Thank you very much. I
19 appreciate it.

20 Go off the record.

21 **(Whereupon, a short recess was taken.)**

22 MR. TOPOROFF: We're back on the record. And Ms. Tidd
23 has asked to be able to speak today on some franchise issues,
24 since she will not be available tomorrow.

25 So the transcript is going to be a little bit out of

1 sequence. We're going to move away from business
2 opportunities, which is the topic for today, to briefly talk
3 about some of the franchise issues that are raised in the
4 Advanced Notice of Proposed Rulemaking.

5 So I'll turn in over to Ms. Tidd.

6 MS. TIDD: Thank you. I wanted to comment briefly on the
7 question of whether or not to require earnings claims in the
8 disclosure statement.

9 Having been involved in franchising in one capacity or
10 another for more than 20 years, I believe it is more valuable
11 in the long run to both franchisor and franchisee to require
12 some form of earnings claim statement. The caveat to that is,
13 of course, the startup franchisor with no track record.

14 The key to making a decision to purchase a franchise, one
15 of the fundamental keys, is obviously, Can I make money; can I
16 make a profit; can I earn a living; how much can I make; is
17 this business going to be successful. And the only way to do
18 that is with some form of earnings claim.

19 Franchisors, because of the history regarding the
20 regulation of earnings claims, even when they are able to put
21 together some form, are -- most franchisors will not do it.
22 They are more comfortable with a position of not saying it.
23 First, fear of liability, that -- because it will always be
24 raised in any form of dispute or litigation with franchisees.
25 And secondly, they have learned how to sell around it, more or

1 less legitimately.

2 If there were a specific "safe harbor" mandated earnings
3 claim so that all franchisors were providing some information,
4 I believe that it would be most helpful to the prospective
5 investor. They would have a more fair basis for comparison
6 between those who do provide disclosure and those who do not.

7 MR. TOPOROFF: Okay. Any other comments?

8 MS. TIDD: Just briefly with regard to the question of
9 whether or not foreign sales, international sales, should be
10 included within the franchise rule for disclosure purposes.

11 I have been involved in international franchising for
12 about 15 years, and it would be unduly burdensome and have no
13 relevance to the international transaction in most cases to
14 provide a domestic disclosure statement. Every deal is
15 materially different. The relationships are restructured to
16 fit the local culture and the local laws, so it simply makes
17 no sense, and, in fact, can be more misleading than not.

18 MR. TOPOROFF: Okay. Anything else you'd like to add?

19 MS. TIDD: I do believe that the three-year staged
20 financial statement aspect of the rule should remain
21 unchanged.

22 MR. TOPOROFF: Okay. Thank you.

23 We'll go off the record.

24 **(Whereupon, at 10:15 a.m., the testimony was concluded.)**

25

1 **C E R T I F I C A T I O N O F R E P O R T E R**

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3 DOCKET/FILE NUMBER: R511003 4 CASE TITLE: Franchise Rule 5 HEARING DATE: October 20, 1997

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8 I HEREBY CERTIFY that the transcript contained herein is
9 a full and accurate transcript of the notes taken by me at the
10 hearing on the above cause before the FEDERAL TRADE COMMISSION
11 to the best of my knowledge and belief.

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DATED: October 26, 1997

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19 **C E R T I F I C A T I O N O F P R O O F R E A D E R**

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21 I HEREBY CERTIFY that I proofread the transcript for
22 accuracy in spelling, hyphenation, punctuation and format.

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25

(LAUREL H. STODDARD)