

## Finding the Balance In Franchise Broker Regulation Among Franchisees, Franchisors And Franchise Brokers

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There has been much discussion in recent months about the scope of franchise broker regulation. Much of the debate has centered on who is properly considered a broker, as well as the regulatory compliance obligations that those who are brokers and the franchisors who deal with them must satisfy.

Some have questioned whether existing regulations are overly burdensome or impractical given the way in which business is conducted today, resulting in a general decline in the level of compliance. In addition, critical concerns have been raised as to whether the existing regulations adequately fulfill the stated regulatory purpose of providing accurate, material presale disclosure to prospective franchisees.

While neither of the authors is a proponent of regulations that serve only to impede franchise sales, both believe that a compelling argument can be made for compliance with existing regulations, not only to protect the interests of franchisees but of franchising, and that measures can be implemented to make franchisors' and brokers' compliance with those regulations less burdensome. The authors further believe that, within the context of the current regulatory scheme, additional or alternative disclosures might serve to further the regulatory objective underlying presale disclosure, serving to avoid other, more intrusive, regulatory regimes.

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## **I. Rationale for Broker Regulation**

As a part of its original rulemaking process, the FTC documented the need to bring franchise brokers “within the ambit of the rule”. Citing testimony “that a great many abuses ‘stem from overzealous independent commission agencies selling franchises without regard to the franchisee’s financial ability or adaptability to the particular franchise,’” the FTC found that franchisees who purchased their franchises from franchise brokers often sustained “serious financial losses”.

Because offers and sales of franchises by unregulated franchise brokers were thought to pose the same danger to prospective franchisees as those by franchisors, the FTC therefore concluded “that franchisees who purchase franchises from franchise brokers or promoters need protection as much as those who purchase from the franchisor itself.”<sup>1</sup>

At the federal level, that protection takes the form of requiring brokers, as well as franchisors, to make material pre-sale disclosures to prospective franchisees. “The goal of the franchise rule is to furnish prospective franchisees with pre-sale information about their proposed investment. Generally, the franchisor is in the best position to provide this information; therefore, the rule places the primary disclosure burden on the franchisor. On occasion, the franchisor does not market its own franchises, but, instead, retains a third party to do so on its behalf. Therefore, the rule extends disclosure obligations onto these third parties, denominated as ‘franchise brokers’ by the rule, who assist in effecting the sale of franchises”<sup>2</sup>

## **II. Who is a Broker?**

### **A. Federal Law**

It is against this background that the FTC Rule<sup>3</sup> broadly defines those who are regulated as franchise “brokers,” as “any person other than a franchisor or a franchisee who sells, offers for sale, or arranges for the sale of a franchise.”<sup>4</sup>

The Interpretive Guides to the FTC Rule further clarify the definition of a franchise broker,<sup>5</sup> stating that an “organizer or promoter of a trade show in which franchises or business opportunities are offered for sale is a ‘franchise broker’ within the meaning of the rule, since such person ‘arranges’ for the sale of franchises”, and that a “sub-franchisor authorized to offer or sell sub-franchises will be a ‘franchise broker’ within the meaning of the rule.”<sup>6</sup> However, “franchisees who sell their own franchise” are not franchise brokers.<sup>7</sup>

The FTC elaborated on the “critical elements” that distinguish a franchise broker in its 1981 Order Granting Conditional Exemption to trade show promoters. In that Order, the FTC found that trade show promoters were franchise brokers in that they “arranged for the sale of franchises”. The FTC based its conclusion on the activities of trade show promoters in “securing exhibition space,” “publicizing the exhibit,” and “supplying exhibitors with supplies and equipment,” all for the purpose of introducing franchisors and prospective franchisees. Those actions made trade show promoters “active participants in the sales chain,” subjecting them to regulation as franchise brokers. “The Commission intended the ‘franchise broker’ definition to cover all parties (other than a franchisor or a franchisee) within the sales chain, including brokers who

actually sell or make offers as well as those who actively participate through any other types of activities or 'arrangements' which directly lead to sales.”<sup>8</sup>

The FTC reached a different conclusion in its January 7, 1983 advisory opinion involving Franchise Referral Association, Inc. (“FRA”). In that opinion, the FTC addressed whether FRA’s members were franchise brokers within the meaning of the FTC Rule. FRA had advised the FTC that its “members” stocked and distributed various franchisors’ promotional information, referred interested prospects to the franchisor for further action, and received a commission of \$1,500 for each franchise sold. FRA members were, however, specifically prohibited by FRA from “encourag[ing], entic[ing], or otherwise persuad[ing]” a person to purchase a franchise. Noting the “passive activity” of FRA’s members, whose sole responsibility [was] to give interested person [sic] copies of material written by franchisors and refer prospects to franchisor”, the FTC stated that FRA’s members would not be deemed brokers.<sup>9</sup> “[P]ersons who make franchisors’ promotional literature available to the public and refer interested persons to the franchisor, *but engage in no sales activities or promotional efforts of any nature* are not franchise brokers as defined in the rule.” [Emphasis added.]

Organizations that provide referrals to franchisors may have taken some measure of comfort from the FRA opinion, concluding that their activities are more “passive” than “active” because they do not, for example, collect money for the franchisor, do not participate in the franchisor’s approval process, and merely refer or introduce prospects to the franchisor in exchange for a fee if the sale closes. However, any such comfort may not be justified, as the FRA opinion was in essence a very limited opinion. Perhaps mindful of human nature, the FTC cautioned at the end of the FRA

opinion that: “It is conceivable that some members who (i) have paid for the opportunity to stock franchisors’ material and (ii) will earn \$1,500 whenever the referral buys a franchise, will not content themselves simply to distribute franchisors’ literature. These members should bear in mind, however, that if their activities go beyond those set forth in your request they will become active participants in the sales chain, and, thus, franchise brokers subject to the rule’s compliance requirements.”<sup>10</sup>

The FTC had the opportunity to re-visit the broker issue in a July 2, 1999 advisory opinion, which responded to the request by a firm representing several franchisors as to whether the independent business consultants with which the franchisors contracted were required to provide prospective franchisees with the franchisors’ disclosure document or Uniform Franchise Offering Circular (“UFOC”) at the time the consultant referred the prospect to a particular franchisor.

As detailed in the request, the consultants had arrangements with various franchisors to provide brochures, other franchise sales information, and franchise offering circulars to prospective franchisees. The consultants worked with the prospective franchisees to determine what franchise opportunity best suited their skills and available resources. Often, the consultant would assist the prospect in completing a franchise application. After submitting the application, the prospect would work directly with the franchisor. If the prospect ultimately purchased a franchise, the consultant would receive a pre-arranged fee.

The FTC found that the consultants were brokers in that they “‘arrange[d]’ for the sale of the franchise by discussing the prospects’ specific business interests, recommending specific franchise options, and even in some instances assisting

prospects in completing the franchisor's application form.” The FTC also noted that signed contracts between the consultants and the franchisors they represented under which the consultants would be paid by the franchisor for their work “clearly indicates that both the consultants and franchisors consider the consultants’ role in prescreening prospects an important part of the overall franchise sales process.”<sup>11</sup>

The FTC issued another advisory opinion on the broker issue on November 12, 1999 in order to clarify certain aspects of the earlier July 2, 1999 opinion. In the later opinion, the FTC examined two brokerage businesses (one focusing on the sale of franchised businesses (“Franchise Network” or “FRANNET”) and the other focusing on the sale of non-franchised businesses (“Tom Miller & Associates” or “TMA”).

FRANNET had arrangements with approximately 75 franchisors under which FRANNET would be paid a fee for any referral that ultimately resulted in the prospect buying a franchise. TMA was a business brokerage firm that primarily arranged for the sale of non-franchised businesses but if a prospect failed to qualify for any of the listed businesses, its brokers might give the prospect information about one or more franchise opportunities on file. The FTC stated that both FRANNET and TMA were clearly “franchise brokers” because they “arrange for the sale of a franchise by introducing prospective franchisees to specific franchise concepts and by putting prospective franchisees in contact with specific franchisors. Moreover, they are paid by the franchisor if a sale is ultimately consummated.”<sup>12</sup>

The FTC’s Notice of Proposed Rulemaking (“NPR”), combines the terms “franchisor” and “franchise broker” used in the current FTC Rule into a new term,

“franchise seller,” and makes clear that all “franchise sellers” have the obligation to provide disclosure.<sup>13</sup>

## **B. State Law**

Of the franchise registration states, only Hawaii, Illinois, New York, Virginia and Washington, have adopted rules or regulations specifically defining or addressing the conduct of franchise brokers. These state franchise laws include broker definitions that are arguably more restrictive than that the federal definition in that they do not include the third component of the federal definition; i.e., the phrase that brings within the broker definition anyone who “arranges for the sale of a franchise”. As noted below, however, states have taken an expansive view of those covered by their broker definitions.

In Hawaii a “franchise broker” or “selling agent” is defined as a person who directly or indirectly engages in the sale of franchises.<sup>14</sup>

Illinois defines a franchise broker as “any person engaged in the business of representing a franchisor in offering for sale or selling a franchise and is not a franchisor or an officer, director or employee of a franchisor.”<sup>15</sup> However, Illinois law also includes as a broker a person that provides a prospective franchisee with information about specific franchises other than the franchisor’s name, address and phone number. Expectation or payment of a fee contingent upon a franchise sale is regarded as evidence of franchise broker status, unless the fee is derived from a sale that Illinois defines as an “isolated transaction”.<sup>16</sup> Franchisees who receive payment from the franchisor for referring a prospective franchisee are specifically exempted from the definition of franchise broker, so long as that franchisee does not otherwise participate in the sale.<sup>17</sup>

New York law refers to franchise brokers as “franchise sales agents” and defines a “franchise sales agent” as any person who engages in the offer or sale of any franchise on behalf of another.<sup>18</sup> Again, franchisors, subfranchisors and their respective employees are exempted from the definition.<sup>19</sup>

Virginia defines a franchise broker as a person engaged in the business of representing a franchisor or subfranchisor in offering for sale or selling a franchise, except anyone whose identity and business experience are otherwise required to be disclosed in Item 2 of the UFOC.<sup>20</sup>

Under Washington law, a franchise broker is defined as a person who engages in the offer or sale of franchises.<sup>21</sup> Franchisors, subfranchisors and their respective officers, directors and employees are exempted from this definition.<sup>22</sup> Washington has also issued an interpretive opinion on the issue of who must register as a franchise broker. Generally, the opinion states that: (i) a person who is an independent agent, contractor, or consultant representing one or more franchisors is deemed to be a franchise broker; (ii) a person who receives commissions or other compensation in connection with the offer or sale of a franchise is deemed to be a franchise broker; (iii) a person who offers or sells two or more franchises is presumed to be a franchise broker; (iv) a person who advertises, promotes or identifies himself as a broker is generally deemed to be a broker; and (v) a person who is an employee of a franchise broker is not in the business of offering or selling franchises and is therefore not deemed to be a broker.<sup>23</sup>

### **III. Broker Regulation**

As noted previously, the FTC Rule's disclosure requirements applicable to franchisors are also applicable to franchise brokers. Both franchisors and franchise brokers must provide disclosure in compliance with the FTC Rule, but disclosure provided by either the franchisor or a franchise broker to a particular prospective franchisee "will constitute compliance by the other."<sup>24</sup> Therefore, under current law, franchise brokers must provide disclosure at the earlier of the "first personal meeting" or 10 business days prior to the execution of any agreement related to the franchise or before the franchisee pays any consideration for the franchise.<sup>25</sup>

In its July 2, 1999 advisory opinion, discussed above, the FTC (after finding that the independent consultants who were the subject of that opinion were brokers) stated that "a face-to-face meeting in which any independent consultant or other sales agent of the franchisor prescreens prospects for the possible sale of a franchise constitutes a 'first personal meeting' under the Rule," and therefore disclosure must be provided at such a meeting.<sup>26</sup>

The FTC further elaborated on what constitutes a "first personal meeting" in the broker context in its November 12, 1999 advisory opinion, also discussed above. In that opinion, the FTC responded to a request for clarification of the "first personal meeting" requirement submitted by two brokers, FRANNET (a franchise consulting firm) and TMA (a general business brokerage firm). FRANNET represented that during its first meeting with prospects, it had the prospect complete a questionnaire to solicit information used to determine which franchise system was the "best fit" for the prospect. Information about one or more franchise systems would then be provided to the prospect. If the prospect showed an interest in any of the proposed franchise systems, FRANNET

would provide additional information about the system(s). If the prospect continued to show an interest in a franchise system, FRANNET would arrange for a meeting with a franchisor representative.

At TMA's initial meeting with a prospective business purchaser, it would attempt to match the prospect with one or more of its listed non-franchised businesses through the use of a questionnaire. Only if there was no match between the prospect and the listed businesses would TMA suggest that the prospect consider one or more franchise businesses and provide information about those franchise systems. If the prospect showed an interest in a franchise system, TMA would provide the prospect's name to the franchisor.

The FTC analyzed the question of whether FRANNET's and/or TMA's first meeting with prospects was a "first personal meeting" within the meaning of the FTC Rule, requiring FRANNET and/or TMA to deliver the franchisor's UFOC at that meeting.

The FTC noted that "a face-to-face meeting constitutes the 'first personal meeting' if the following factors, among others, are present: The franchisor's representative or independent agent meets personally with consumers in a setting where there is a likelihood or expectation of discussing the possible purchase of a franchise. During the meeting, the representative or agent: (1) seeks to match the consumer with one or more specific franchise systems based upon criteria furnished by the consumer; (2) discusses the merits of one or more specific franchise systems; and (3) contacts the franchisor on behalf of the consumer or otherwise advises the consumer on how to contact one or more franchise systems. Finally, the representative

or agent receives a commission or other compensation if a franchise sale is ultimately consummated through the referral.”

Based on these factors, the FTC found that FRANNET’s first meeting with the prospect constituted a “first personal meeting”. Of significance in its analysis, was the fact FRANNET was focused on franchise sales and that FRANNET’s “primary, if not sole, source of income . . . comes from generating franchise sales.” Also, FRANNET went into the first meeting with its primary objective being to discuss the possible sale of a franchise.

On the other hand, TMA did not “arrange the meeting with their clients with the expectation of discussing franchise sales. . . . Discussions of franchising apparently are incidental at most, limited only to those occasions where a sale of a listed business is not a viable option.” Additionally, the questionnaire that TMA’s clients’ completed at the initial meeting solicited information regarding the clients’ interest in purchasing non-franchised businesses. The FTC found, therefore, that TMA’s first meeting with clients was not a “first personal meeting”.<sup>27</sup>

Of course, the issue of what constitutes a “first personal meeting” and the logistical difficulties encountered by brokers required to stock a sufficient number of UFOCs to meet their disclosure obligations at such “first personal meetings” may become moot if certain changes to the FTC Rule are adopted. As proposed, the new FTC Rule would eliminate the requirement that disclosure be made at the “first personal meeting” and would instead require disclosure at least 14 calendar days before the franchisee signs any agreement related to the franchise or pays any consideration for the franchise.<sup>28</sup>

In addition to requiring both franchisors and franchise brokers to make disclosure to prospective franchisees at the prescribed times, franchisors who use franchise brokers are required to disclose in their UFOCs certain information about the broker. The UFOC Guidelines<sup>29</sup> require that brokers' current position(s) and five year employment history be disclosed in Item 2. The Item 2 instructions state that "[i]n a multi-state offering in which the franchisor uses a single offering circular and franchise brokers . . . differ[] from state to state, an exhibit should be used to refer to those [brokers]."<sup>30</sup> The litigation disclosure requirements in Item 3 apply to brokers. Therefore, administrative, criminal or material civil actions in which any broker is currently a party or has been a party within the 10 years immediately preceding the date of the UFOC alleging violations of franchise, antitrust or securities law, fraud, unfair or deceptive trade practices or comparable allegations or any other "significant" actions must be disclosed.<sup>31</sup> And, if current proposed changes to the FTC Rule are adopted, a broker's bankruptcy history will have to be disclosed in Item 4.<sup>32</sup>

Apart from disclosure requirements, various state laws require that franchise brokers register and maintain certain records. Hawaii imposes a record-keeping requirement on every person selling franchises in the state. These persons are required to keep records of the sales made in the state and, when requested, must file a report listing the franchises sold and the proceeds derived from each sale.<sup>33</sup>

In Illinois, it is unlawful for an unregistered broker to offer for sale or to sell a franchise that is required to be registered in Illinois.<sup>34</sup> A franchise broker registers in Illinois by filing: (i) a broker application form; (ii) a certification page; (iii) a salesperson disclosure form; (iv) a corporate, partnership or individual acknowledgment; (v) a

consent to service of process; and (vi) a broker authorization form.<sup>35</sup> Brokers authorized to accept payments on behalf of a franchisor must comply with certain net worth requirements.<sup>36</sup> The registration is effective for one year and must be renewed annually. The cost of registration and renewal is \$100.<sup>37</sup>

Under New York law, a person is prohibited from offering to sell or selling a franchise on behalf of a franchisor or subfranchisor, unless the person files a franchise agent's application with the department of law.<sup>38</sup> When registering as a franchise sales agent, each applicant must pay a fee of \$150. The department may deny, suspend, or revoke a sales agent registration if the department determines that the sales agent in question has failed to comply with certain regulations issued by the department.<sup>39</sup> To register, a sales agent must file a Sales Agent Disclosure Form. Each registered sales agent must update his or her Sales Agent Disclosure Form if one or more of the following changes takes place: (i) the registrant undergoes a name change; (ii) the registrant changes his or her business address or opens new branch offices in New York; (iii) the registrant undergoes changes in its officers, directors, general partners or other principals; and (iv) the registrant is the subject of any criminal action, or is convicted of a misdemeanor or felony, is the subject of any injunction or cease and desist order relating to the offer or sale of securities or franchises or is the subject of a money judgment or injunction in a civil action involving fraud, embezzlement, fraudulent conversion or misappropriation of property.<sup>40</sup>

Other than including a definition of "franchise broker" in its regulations, the Virginia rules and regulations do not impose any reporting or registration requirements on franchise brokers.

In the state of Washington, a franchise broker may not offer or sell a franchise unless he or she is registered with the state. Likewise, it is unlawful for a franchisor to employ an unregistered franchise broker. To register in Washington, a franchise broker must file an application and a consent to service of process, and pay a registration fee (\$50.00 for initial registrations and \$25.00 for each annual renewal).<sup>41</sup> Washington franchise brokers must also comply with certain record-keeping requirements including: (i) records of each franchise sale, the party or parties to whom it was sold, the aggregate price, the amount paid up-front, the installment payments (if applicable), the commission paid to the broker, the amount dispersed for advertising and other amounts to be funded to the franchisor; (ii) an individual registration card for each franchisee including the franchisee's name and address, aggregate amount to be paid, terms of the payment, and a copy of the receipt signed by the purchaser indicating that he received a copy of the offering circular at least ten business days before the sale; (iii) copies of all advertising used in the sale of the franchise; and (iv) for a period of not less than six years, all records, books, and memorandums relating to the franchisee.<sup>42</sup>

#### **IV. Effecting Compliance With Broker Regulation**

As discussed above, underlying the rationale for broker regulation is the belief that everyone actively involved in the franchise sales process should be obligated to provide material disclosures to prospective franchisees. While the FTC Rule and state statutes mandating disclosure are premised on protecting the interests of the franchisee, we have seen as franchising has matured that concise and accurate presale disclosure of material information has furthered the interests of franchising and (arguably) obviated the need for further relationship regulation. Compliance with

regulations designed to foster material presale disclosure by all involved in the sales process is essential to the integrity of the current regulatory scheme and to the avoidance of other, more intrusive, regulatory requirements.

It is clear from the preceding discussion that existing regulatory requirements capture a broad range of participants in the franchise sales process. Notwithstanding the inclusiveness of the regulatory umbrella, however, a number of practical difficulties related to the current scheme of broker regulation have been noted which may prove a disincentive to compliance. Among them are the concern that changes in the broker ranks may be “material,” requiring multiple UFOC amendments and necessitating the suspension of franchise sales. In addition, there are various logistical difficulties, including: (i) the difficulty that brokers who represent large numbers of franchise companies have in satisfying the UFOC delivery requirements at the “first personal meeting”<sup>43</sup>; (ii) the difficulty franchisors have in satisfying the broker disclosure requirements if given a lead by a broker with whom it has had no pre-existing relationship<sup>44</sup>; and (iii) the difficulty that both brokers and franchisors have in satisfying the current broker disclosure and registration requirements in the case of large broker networks comprised of multiple independent contractors<sup>45</sup>.

While the practical difficulty of complying with a regulatory requirement is not a valid argument for dispensing with that requirement, all parties involved would benefit from efforts to minimize those difficulties. Necessary to ameliorating some of the practical difficulties of compliance is a recognition by all parties of the rules that apply and the undertaking of a cooperative effort to satisfy them. Brokerage firms should be prepared to cooperate with franchisors to provide the information needed for the

franchisor's UFOC, to ensure that each consultant in the broker's network complies with applicable federal and state requirements, and to notify the franchisor promptly of any changes in the network and with respect to individual brokers that would affect the franchisor's activities. Franchisors should accurately disclose broker relationships and provide to the broker network any standards used by the franchisor in screening applicants or conducting sales. Each party should be prepared to indemnify the other for any failure to comply with their respective obligations. In appropriate circumstances, brokers' Errors and Omissions insurance coverage in which the franchisor is listed as an additional insured might also be considered.

One commentator has detailed a cooperative effort between franchisors and a broker network designed to solve the administrative difficulty of providing timely and accurate disclosure regarding the members of large broker networks and securing the requisite state registrations by the member brokers. That effort involves preparation by the broker of a generic UFOC exhibit, containing all relevant information about the broker network, its officers, directors and members. This exhibit and related salesman disclosure forms are delivered to the franchisors with whom the broker works to include in their respective UFOCs. Disclosures are updated and appropriate state filings are amended when the franchisor receives a referral from a new, previously undisclosed member of the network. The network itself effects registration of it and its constituent members in those states (Illinois, New York and Washington) where separate broker registration is required.<sup>46</sup>

An interesting proposal for reducing the regulatory burden seeks to resolve the difficulties presented by "drop in" brokers. Coining this phrase to describe those lead

referral networks that qualify as franchise brokers but with which a franchisor has no pre-existing relationship, this commentator suggests that the franchisor's (and the broker's) disclosure obligations could best be met by providing the prospective franchisee with a supplemental disclosure document delivered with, or shortly after, the delivery of the UFOC.<sup>47</sup> This supplemental disclosure document (which is not permitted under current law) would describe the broker's relevant business experience (as required by Item 2 of the UFOC Guidelines), any relevant litigation history (as required by Item 3 of the UFOC Guidelines), and any bankruptcy history that may be required if proposed changes to the FTC Rule are adopted.<sup>48</sup>

Another suggestion for lessening the regulatory burden is the possibility of a broker exemption to address the practical difficulty of making disclosures of multiple franchise opportunities at "first personal meetings" held by brokers. Under such an exemption, brokers that hold first personal meetings would be exempt from providing the UFOCs of each franchise discussed at that first personal meeting and instead would be required to provide a consumer education notice which, among other things, would state that the network is being compensated by the franchisors for their referral services.<sup>49</sup> This exemption would be analogous to the exemption granted trade show promoters in 1981. Although finding that trade show promoters were brokers within the meaning of the FTC Rule, the FTC granted promoters an exemption from providing disclosure if they distributed a consumer education notice to trade show attendees, advising them of their legal right to receive such disclosure.<sup>50</sup>

## **V. Impact of Broker Regulation**

But efficiencies in satisfying existing regulatory obligations do not address whether those existing requirements fulfill the overarching regulatory purpose of providing all material presale disclosures to prospective franchisees. Under the current scheme, brokers are fundamentally equated with the franchisors they represent: franchisors and brokers must disclose information about the franchise and comply with separate registration requirements in those states requiring registration. While this approach is certainly consistent with many of the perceived dangers that the FTC found associated with broker participation in the sales process, the FTC noted other concerns that do not appear to be addressed by the disclosures that are currently required.

As described by the FTC in the Statement of Basis and Purpose, it may not be easy to discern the interests of a franchise broker, especially those consultants who may appear to represent the interests of the franchise prospect but who are compensated by the franchisor. The FTC noted the necessity of “clearly identifying the relationship between the franchisor and franchise broker”, and the fact that franchise brokers may receive commissions from franchisors if a franchise sale is made.<sup>51</sup> Included as a part of the original record is an excerpt from *Franchised Distribution*, which observes that “[a] ‘franchise broker’ may operate from a permanent franchise showroom: ‘The person manning a permanent ‘business opportunity’ showroom sometimes identifies himself as a franchise ‘consultant.’ This would seem to suggest that the consulting he performs is for the benefit of the prospective franchisee. But the consultant receives his compensation from the franchise company and in reality he represents the interests of that company rather than the would-be franchisee.’”<sup>52</sup>

Significantly, several of the commentators who have recently addressed the subject of broker regulation have suggested the need for a disclosure that is not required under current law; that is, a disclosure “stating that the named lead referral source who referred the prospect to the franchisor will receive a significant commission from the franchisor (without specifying the dollar amount or any percentage of the initial fee) and, if applicable, that the commission will only be payable if the prospect purchases a franchise from the franchisor.” As noted by the author, “Amazingly, this particular disclosure is not legally required under either the current UFOC Guidelines or the proposed new FTC Rule. However, it is probably the single most critical piece of information to insure that the prospect understands the lead referral source’s significant economic incentive to encourage the sale.”<sup>53</sup>

It has been observed that such compensation disclosures “would also help stem recent criticisms of lead referral networks that their clients may be unaware that lead referral networks receive compensation from franchisors, and that lead referral networks may only be in a position to recommend franchises from those companies they represent.”<sup>54</sup>

One of the authors of this article has previously noted the importance of such a disclosure, as well as of disclosures by franchise brokers of the franchisor clients they represent and the criteria upon which they base their recommendations of specific franchisors.<sup>55</sup> It is difficult to understand how this information is not a material disclosure. However, franchisors are not in the best position to provide this information. While franchisors may have information about their own broker arrangements, they are not in a position to know the terms of the arrangements that a broker may have with

other franchisors. Indeed, the franchisor may not know the other franchisors a broker represents. Only the broker has full access to that information.<sup>56</sup>

Mindful of the approach taken by the FTC in its 1981 order granting trade show promoters an exemption from delivery of the UFOC, one possibility for disseminating this information (noted above) is through a consumer education notice distributed by brokers when they meet with prospective franchisees. Such a notice could simply state that the broker represents some, but not all, franchise companies and (if true) that its recommendations will be limited to those companies it represents. The notice would also state that the broker will receive a commission if the prospect purchases a franchise from a company to which the prospect is referred by the broker and that the commissions paid by franchise companies may vary.

It is difficult to understand how the regulatory burden would be significantly increased if brokers (who now are required to provide the franchisor's UFOC) were required to distribute a notice to prospective franchisees containing such information.

## VI. Conclusion

The requirement to deliver material information to prospective franchisees before they purchase the franchise has helped improve the reputation of franchising. Continued compliance with that requirement by franchisors and brokers, combined with the delivery of all information material to the prospective franchisee's evaluation of the franchise opportunity, is important to preserve the reputation that all those involved in franchising have worked so hard to achieve and perhaps to avoid additional layers of regulation.

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<sup>1</sup> Bus. Franchise Guide (CCH) ¶6358.

<sup>2</sup> 46 FR 52327 (October 27, 1981)

<sup>3</sup> 16 C.F.R. § 436.1 reprinted at Business Franchise Guide (CCH) ¶ 6090-6150.

<sup>4</sup> 16 C.F.R. § 436.2(j), reprinted at Bus. Franchise Guide (CCH) ¶6160.

<sup>5</sup> 44 Fed. Reg. 49966, reprinted at Bus. Franchise Guide (CCH) ¶6219.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> 46 Fed. Reg. 52327 (1981)

<sup>9</sup> Bus. Franchise Guide (CCH) ¶6436.

<sup>10</sup> *See id.*

<sup>11</sup> Informal Staff Advisory Opinion 99-6, July 2, 1999, Bus. Franchise Guide (CCH) ¶6436.

<sup>12</sup> Informal Staff Advisory Opinion 99-7, November 12, 1999, Bus. Franchise Guide (CCH) ¶6504.

<sup>13</sup> 64 Fed. Reg. 57294.

<sup>14</sup> Haw. Rev. Stat. § 482E-2, reprinted at Bus. Franchise Guide (CCH) ¶3110.02.

<sup>15</sup> Ill. Comp. Stat. 705/3, reprinted at Bus. Franchise Guide (CCH) ¶3130.03.

<sup>16</sup> Ill. Admin. Code tit. 14, §200.116, reprinted at Bus. Franchise Guide (CCH) ¶5130.143.

<sup>17</sup> *See id.*

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18 N.Y. Gen. Bus. Law § 681, reprinted at Bus. Franchise Guide (CCH) ¶3320.02.

19 *See id.*

20 Va. Admin. Code § 5-110-10, reprinted at Bus. Franchise Guide (CCH) ¶5460.01.

21 Wash. Rev. Code § 19.100.010, reprinted at Bus. Franchise Guide (CCH) ¶3470.01.

22 *See id.*

23 Wash. Admin. Code Interpretive Statements No. FIS-6, reprinted at Bus. Franchise Guide (CCH) ¶5470.80.

24 16 C.F.R. §436.1, reprinted at Bus. Franchise Guide (CCH) ¶6090, and 44 Fed. Reg. 49966, reprinted at  
Bus. Franchise Guide (CCH) ¶6219.

25 16 C.F.R. §436.1, reprinted at Bus. Franchise Guide (CCH) ¶6090.

26 Bus. Franchise Guide (CCH) ¶6503.

27 Bus. Franchise Guide (CCH) ¶ 6504.

28 Notice of Proposed Rulemaking, 64 Fed. Reg. 57294, 57300-301 (October 22, 1999).

29 Bus. Franchise Guide (CCH) ¶ 5781.

30 Bus. Franchise Guide (CCH) ¶5754.

31 Bus. Franchise Guide (CCH) ¶5755.

32 Notice of Proposed Rulemaking, *supra*, note 28.

33 Haw. Rev. Stat. § 482E-5, reprinted at Bus. Franchise Guide (CCH) ¶3110.05.

34 Ill. Comp. Stat. 705/5, reprinted at Bus. Franchise Guide (CCH) ¶3130.05.

35 Ill. Admin. Code tit. 14, §200.900, reprinted at Bus. Franchise Guide (CCH) ¶5130.55.

36 *See id.*

37 Ill. Comp. Stat. 705/40, reprinted at Bus. Franchise Guide (CCH) ¶3130.40.

38 N.Y. Gen. Bus. Law § 683, reprinted at Bus. Franchise Guide (CCH) ¶3320.04.

39 N.Y. Comp. Codes R. & Regs. tit. 13 § 200.4, reprinted at Bus. Franchise Guide (CCH) ¶5320.04.

40 N.Y. Comp. Codes R. & Regs. tit. 13 § 200.11, reprinted at Bus. Franchise Guide (CCH) ¶5320.11.

41 Wash. Rev. Code § 19.100.140, reprinted at Bus. Franchise Guide (CCH) ¶3470.14.

42 Wash. Admin. Code § 460-82-200, reprinted at Bus. Franchise Guide (CCH) ¶5470.51.

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<sup>43</sup> David A. Beyer, “Franchise Lead Referral Networks: Brokers or Consultants?”, *Franchising World*, May/June 2003

<sup>44</sup> Judith M. Bailey, “Disclosure About Lead Referral Sources,” [cite to follow]

<sup>45</sup> Beyer, *supra*, note 43 and sidebar by Brian Schnell

<sup>46</sup> *Supra*, note 43, sidebar by Brian Schnell.

<sup>47</sup> Presumably the broker will independently satisfy any applicable state registration requirement. The question of whether brokers would be required to identify the specific franchise system(s) with which they work when they register remains open.

<sup>48</sup> Bailey, *supra*, note 44.

<sup>49</sup> Beyer, *supra*, note 43. As noted by the author, this issue may ultimately resolve itself, as the proposed changes to the FTC Rule eliminate the concept of the first personal meeting and the related requirement to give disclosure at that meeting

<sup>50</sup> 46 Fed. Reg. 52,327 (1981)

<sup>51</sup> Bus. Franchise Guide (CCH) ¶6358.

<sup>52</sup> *Id.*

<sup>53</sup> Bailey, *supra*, note 44.

<sup>54</sup> Beyer, *supra*, note 43.

<sup>55</sup> Michael H. Seid, “Franchise Brokers – Is Integrity in the Franchise Sales Process Really That Much of a Burden?” [cite to follow]

<sup>56</sup> Thus, if such disclosures were to be required, the liability for failure to make the disclosures should rest with the broker. This is similar to the approach taken by the FTC in the NPR, clarifying broker liability for the contents of the UFOC. Under the current FTC Rule, brokers are jointly liable with the franchisor for the contents of the disclosure. Under the new FTC Rule, any franchise seller other than the franchisor is liable for the contents of the disclosure only to the extent that the franchise seller knew or should have known of the violation.