

UNIDROIT 2001
Study LXVIII – Doc. 35
(Original: English)

UNIDROIT
INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
=====

COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A
MODEL FRANCHISE DISCLOSURE LAW

First session
(Rome, 25 - 29 June 2001)

Comments submitted by the United States

Rome, June 2001

PROPOSED ADDITION TO THE PREFACE

Parts 1 and 2 of the Explanatory Report should be moved to the front of the document, before the text of the Model Law. The following should be inserted prior to paragraph 1 of the Preface:

This model law exists in order to provide guidelines to the states that have determined that there is a need for adoption of a pre-sale franchise disclosure law.

This Model Law is not intended to be a recommendation that there is a need for a particular state to adopt a franchise specific law and must be considered as an example that is not compulsory for state legislators.

In the legislative process, national legislators may wish to consider a number of different elements, including

- whether it is clear that there is a problem, what its nature is, and what action, if any, is necessary;
- whether there is a pattern of widespread abusive conduct, or whether this conduct is isolated or limited to particular industries;
- what the nature of the evidence of abuse is, whether it is empirical or only anecdotal;
- whether existing laws address the concerns and whether they are adequately applied;
- whether a system of self-regulation exists and if so whether or not it is sufficiently effective to address the concerns;
- what financial burden the new legislation will place upon franchisors and the extent to which this financial burden will be passed on to franchisees and ultimately to consumers;
- whether the proposed legislation will constitute a barrier to entry to small and new franchisors, including foreign franchisor, and if so what the effects may be in terms of job-creation and investment;

and

- what the views of the national franchise association are.

Further, the Model Law is intended to encourage the development of growth of franchising as a vehicle for conducting business. As a pro-commerce document, it recognizes that franchising offers the potential of increased economic development, especially among countries seeking access to know-how.

A disclosure law may be considered as a means to create a secure legal environment between all the parties in a franchise agreement.

To that end, the Model Law ensures that investors receive material information about franchise offerings with which to make an informed investment decision.

Furthermore, the Model Law bring security to franchisors in their relationships with franchisees, administration and courts.

State legislators should also consider that some disclosure requirements may discourage foreign investors from expanding into their market. Therefore, legislators should weigh the interests of both the franchisor and franchisee when considering whether to adopt any specific disclosure requirement. For example, the imposition of specific accounting standards may inhibit franchisors from expanding. The State should weigh the importance of requiring its accounting standard with the desire for greater foreign expansion in their market.

ARTICLE 2 – DEFINITION OF DISCLOSURE DOCUMENT

Background:

It is unclear from the text of the Model Law whether the disclosure document should be a single document, as opposed to several that might be turned over at different times. Although the definition (“a document”) suggests that it must be a single document, as does paragraph 39 of the Explanatory Report, the other provisions, such as Article 4’s statement that any format may be used, could be interpreted differently. The draft Model Law should be modified to clarify that a disclosure document should be a “single” document. This requirement better ensures that a prospective franchisee will receive all material disclosures at once. For example, we would not want a franchisor to provide a prospective franchisee with its litigation disclosures on a separate sheet of paper that could easily be misplaced.

Proposed Revision to Definition of Disclosure document:

Insert the word “single” before “disclosure document.”

disclosure document means a single document containing the information required under this law.

At the same time, the commentary should be modified to emphasize that attachments to the core disclosure document are acceptable.

Proposed Revision to Explanatory Report:

Change the 3rd sentence of paragraph 39 to read as follows:

The information to be disclosed must be provided in a single document, as opposed to several. Nonetheless, items such as financial statements might usefully be annexed to the disclosure document.

ARTICLE 2 – DEFINITION OF PREDECESSOR

Background:

We have proposed adding predecessors of the franchisor to some of the disclosure requirements included in Article 6. Therefore, we need a definition of the term.

Proposed Definition:

Predecessor means any legal entity from whom the franchisor acquired directly or indirectly the major portion of the franchisor's assets.

ARTICLE 3(2) UPDATING**Background:**

The draft Model Law would require the updating of the disclosure document within an unspecified number of days of the end of the franchisor's fiscal year. The Explanatory Report should provide guidance for states in choosing the number of days. Specifically, the Report should explain that the time period selected by a state should be reasonable to allow sufficient time for the completion of the audit.

Proposed Revision to Explanatory Report:

¶ 54. *Paragraph (2)* introduces the requirement that the disclosure document be updated within a certain number of days of the end of the franchisor's fiscal year However, although the updating is tied to the end of the franchisor's fiscal year and therefore to the production of annual financial statements, the formula is left flexible, as the applicable rules differ from country to country. The intention is to avoid placing a burden on the franchisor that would be disproportionate to the benefit gained by the franchisee. At the very least, the time period selected should be reasonable to allow sufficient time for the franchisor to complete its financial audit

ARTICLE 4 - ELECTRONIC DISCLOSURE**Background:**

The Explanatory Report is neutral on whether states should interpret the requirement that the disclosure be in writing to include electronic documents. Given the increasing acceptance of electronic forms communication, the Report should be revised to affirmatively recommend (but not require) that states accept that electronic documents fulfill the writing requirement.

Proposed Revision to Explanatory Report:

¶ 56 Paragraph (1) requires disclosure to be provided in writing. The provision included in the UNCITRAL Model Law represents modern international standards. Accordingly, States are encouraged to accept that electronic documents fulfill the writing requirement.

ARTICLE 5(A) AND (C) – EXEMPTION FOR TRANSFERS

Background:

Each paragraph contemplates an individual franchisee when using the term “person.” Since most international franchisees are a corporation or similar entity, the exemption should apply when an individual meeting the requirements in (A) or (C) either controls the franchisee or is actively involved in the management of the franchisee’s business.

Proposed Revision of Article 5(A) and (C):

Insert the following after the word “person” in 5(A) and (C):

“(or an entity controlled by such a person or an entity where such a person is primarily responsible for the day-to-day management of the franchisee’s business)”.

ARTICLE 5(B) - EXEMPTION FOR TRANSFERS**Background:**

The Article 5 exemption for transfers is unnecessarily broad. A transfer should be exempted from disclosure only if: (1) the transferee is bound by substantially the same terms as the transferor and (2) the franchisor has not been actively involved in the transfer.

Proposed Revision to Article 5(B):

(B) in case of the assignment or other transfer of a franchisee’s rights and obligations under an existing franchise agreement, where the assignee or transferee is bound by substantially the same terms as the assignor or transferor, and the franchisor has not had a significant role in the sale other than approval (including qualification and training).

EXPLANATORY REPORT PARAGRAPH 60 - TRANSFERS**Background:**

This paragraph needs to be revised to conform to the proposed change to the text of the Model Law.

Proposed Revision to Explanatory Report:

¶ 60. *Paragraph (B)* excludes disclosure in the case of an assignment or other transfer of a franchisee’s rights and obligations under specific conditions, both of which must be met in order for the exemption to apply. First, the assignee or transferee must be bound by substantially the same terms as the assignor or transferor; where, in other words, the only significant change is the name of the franchisee who signs the agreement. The reason for that is that in such cases a franchisee who transfers or assigns a franchise agreement may pass everything over to the new franchisees, including the information he/she received at the beginning of his/her franchise relationship with the franchisor, and if nothing significant is to change in the relationship except one of the parties, new disclosure is not required if

the second condition is met. The second condition is that the franchisor must have been uninvolved in the transfer, other than merely approving the transfer, including qualifying the assignee or transferee as an acceptable franchise owner and providing some initial training. Where the franchisor is uninvolved, the transferee does not rely on any representations of the franchisor made to induce the transfer. However, where the franchisor makes new representations to the transferee, then the transaction is substantially similar to the sale of a new franchise, triggering the franchisor's disclosure obligation.

ARTICLE 5(G) – EXEMPTIONS FOR MINIMAL PAYMENTS

Background:

Article 5 (G) creates, probably inadvertently, the potential for an extremely broad loophole. By allowing an exemption where the total payments required to be made “every” year are less than a specified amount, this provision could be interpreted as permitting the franchisor to require a significant, one-time, post-sale payment without the benefit of disclosure.

Proposed Revision to Article 5(G):

(G) where the total of the payments contractually required to be made by the franchisee to the franchisor or affiliate of the franchisor from any time before to within [x] months after commencing operation of the franchised business is less than [Z].

Proposed Revision to Explanatory Report:

¶ 64 At the opposite end of the spectrum to the exemptions for large investments and large franchisors, is the exemption contained in *Paragraph (G)* for cases where the total payments that the franchisee is contractually required to make to the franchisor or affiliate are less than a certain amount. The intention is to exempt very small arrangements. For example, it ensures that the franchisor does not circumvent the disclosure requirement by requiring very small payments pre-sale sufficient to benefit from the exemption, only to subsequently require substantial payments post-sale, permitting the franchisor to recover all that it has forfeited during the pre-sale phase. . . .

ARTICLE 6(1)(D) - A DESCRIPTION OF THE BUSINESS

Background:

Use of the term “franchisor” in Article 6 (D) may be too limiting, effectively prohibiting a franchisor from disclosing information about its affiliates. This is especially true if the franchisor establishes a new, local subsidiary, which is often the case in international franchise sales. At the same time, franchisors should not have to disclose information about every subsidiary or corporate-owned trade name. Accordingly, the text should be revised by adding to franchisor the phrase “and affiliates of the franchisor which are offering franchises

under substantially the same trade name”. NOTE that there is already a definition of “affiliate of the franchisor” in article 2; and the phrase “affiliate of the franchisor” is used throughout the Model Law. We cannot simply add “offering franchises under substantially the same trade name” to the article 2 definition, because it would narrow the scope of the definition, which would result in unintended consequences in other articles. Therefore, the best way to resolve the problem is to add the qualifier “offering franchises under substantially the same trade name” in those provisions where we want the narrower definition.

Proposed Revision to Article 6(1)(D):

- (D) a description of the business experience of the franchisor and its affiliates offering franchises under substantially the same trade name, including:
- (i) the length of time during which each has run a business of the type to be operated by the franchisee; and
 - (ii) the length of time during which each has offered franchises for the same type of business as that to be operated by the franchisee.

ARTICLES 6(1)(F) AND (G) - LITIGATION/BANKRUPTCY

Background:

Articles 6(1)(F) and 6(1)(G) are too narrow. First, if a franchisor’s affiliates prior experience is material to prospective franchisees, as noted in the discussion of Article 6(D), then the franchisor’s affiliates litigation and bankruptcy history certainly should also be deemed material and disclosed in Articles 6 (F) and 6(G). Second, litigation history should not be limited to matters involving fraud and misrepresentation. This creates an enormous loophole, depriving prospective franchisee of material information about the franchisor and its system. Rather, it should include: violations of a franchise, antitrust or securities law, fraud, and unfair or deceptive practices. Franchisors also should disclose material civil suits filed by franchisees involving the franchise relationship, related arbitrations, as well as suits, which in aggregate, are deemed material. The phrase “involving the franchise relationship” should be explained in the Explanatory Report. Finally, franchisors should disclose similar information about its predecessors.

Proposed Revision to Article 6(1)(F):

- (F) the following information regarding litigation or other legal proceedings:
- (i) relevant details concerning any criminal convictions, or any finding of liability in a material civil action or arbitration, within the last five years, involving franchises or other businesses, and relating to a violation of a franchise, antitrust, or securities law, fraud, misrepresentation, unfair or deceptive practices, or similar acts or practices, against any of the following ;
 - (a) the franchisor and any predecessor of the franchisor;
 - (b) any affiliate of the franchisor which is offering franchises under substantially the same trade name and any predecessor of such an affiliate which is offering franchises under substantially the same trade name; and
 - (c) any of the persons indicated in subparagraph(E);

- ii) relevant details concerning any finding of liability in a material civil action or arbitration involving the franchise relationship brought within the last five years by current or former franchisees against any of the persons or entities indicated in subparagraph (i); and
- (iii) relevant details of any material pending matter of the same nature as set forth in subparagraph (i) or (ii).

Proposed Additional Paragraph to Explanatory Report:

¶ 76 bis. Sub-Paragraph (F) requires franchisors to disclose material lawsuits filed within the last five years by current or former franchisees against the franchisor that involve the franchise relationship. Typically, this will concern suits in which one or more franchisees allege that the franchisor has breached its contractual obligations under the franchise agreement either by failing to provide, for example, promised assistance, training, or advertising, or by unilaterally revising the existing franchise agreement's terms and conditions. It would not include suits by a franchisee against a franchisor for matters arising outside of the franchise agreement, such as a personal injury suit brought by a franchisee who happened to fall while visiting the franchisor's office.

Proposed Revision to Article 6(1)(G):

- (G) relevant details concerning any bankruptcy, insolvency, or comparable proceedings involving any of the legal entities or persons identified in subparagraph (E) or (F) for the previous five years.

ARTICLE 6(1)(H) - NUMBER OF FRANCHISEES

Background:

Article 6(H) may go too far, requiring the disclosure of information that may be irrelevant to individual prospective franchisees. In particular, the term "network" may be unnecessarily broad. The disclosure should be limited to franchisees of the franchisor and affiliates operating under substantially the same trademark.

Proposed Revision to Article 6(1)(H):

- (H) the total number of franchisees of the franchisor and of affiliates of the franchisor offering franchises under substantially the same trade name.

ARTICLES 6(1)(I) AND (J) - FRANCHISEE INFORMATION

Background:

These provisions suffer from the same defect as Article 6(1)(F); namely, they fail to include information about franchisees of affiliates. In addition, the Explanatory Report should address the master franchisee situation.

Proposed Revision to Articles 6(1)(I) and (J):

(I) the names, business addresses and business phone numbers of the franchisees of the franchisor and of the franchisees of any affiliates of the franchisor which are offering franchises under substantially the same trade name whose outlets are located nearest to the proposed outlet of the prospective franchisee, . . .

(J) information about the franchisees of the franchisor and of any affiliates of the franchisor that offer franchises under substantially the same trade name that have ceased to be franchisees during the three fiscal years before the one during which the franchise agreement is entered into . . .

Proposed Revision to Explanatory Report:

¶ 79. Insert the following after the first sentence:

“Where a franchisor sells master franchises, the franchisor should also include in its disclosure document information about master franchisees and their franchisees.”

¶ 80. Insert the following after the first sentence:

“As in Sub-Paragraph (I), a franchisor selling master franchises should also include in its disclosure document information about master franchisees and their franchisees who have similarly ceased to be franchisees of the franchisor during the relevant time period.”

ARTICLE 6(1)(L) - SOURCE RESTRICTIONS

Background:

Article 6 (L) lacks an important disclosure: the manner in which the franchisor issues and modifies specifications or grants and revokes approval to suppliers. In addition, clause (iv) requires the disclosure of “information on pricing practices.” This is vague to the point that franchisors would not know how to comply and it offers an open invitation to unscrupulous franchisees to assert spurious claims based on it. It should be deleted.

Proposed Revision to Article 6(1)(L):

(L) information on goods and/or services that the franchisee is required to purchase or lease, indicating

(iii) the manner in which the franchisor issues and modifies specifications or grants and revokes approval of suppliers;

...

ARTICLE 6(1)(M)(i)(A) - AN ESTIMATE OF THE FRANCHISEE'S INITIAL INVESTMENT**Background:**

This provision requires a disclosure of initial costs. This may prove difficult in international franchise sales, especially where the franchisor is entering into the market for the first time. Indeed, the franchisor may be relying on the prospective franchisee to supply that information. The Explanatory Report should be revised to make this point clear and to also make clear that a reasonable estimate may be based upon the franchisor's experience involving similar franchise sales in other countries.

Proposed Revision to Explanatory Report:

¶ 88. *Sub-Paragraph (M)* deals with financial matters. . . . The provision requires only that the franchisor provide a reasonable estimate of the franchisee's total initial investment. The precise manner in which an estimate should be presented to the prospective franchisee is left to the franchisor to decide. While disclosure of initial costs is obviously material to the franchisee, this may prove quite difficult for a franchisor to provide, especially a franchisor entering a foreign market for the first time. Indeed, in such circumstances, the local prospective franchisee may be in the best position to calculate costs, such as local real estate and labor costs, and the franchisor may be relying on the prospective franchisee to supply that information. Accordingly, the franchisor is required to provide the prospective franchisee with only a reasonable cost estimate based upon information the franchisor already possesses or can easily obtain. The franchisor need not incur the cost of preparing, for example, in-depth market analyses in the foreign country. Rather, an estimate could be based upon the sale of a substantially similar franchise in another identified country. Because the cost disclosures are only estimates at best, they should never be considered a guarantee, and prospective franchisees should understand that the ultimate cost of developing a franchise may be substantially revised during the course of negotiations.

ARTICLE 6(1)(M)(i)(c) - AUDITS**Background:**

This provision may be too limited in that it fails to consider the financial experience of the franchisor's affiliates. Franchisors ought to be able to use parent company financial statements instead of requiring auditing at the franchisor level. In addition, while the Model Law does not indicate which accounting standards should be used, states may be inclined to require that the financials comply with the accounting standards of the place where the franchise is to be operated. This may well discourage a franchisor from entering a particular market, as the time and expense of preparing a second set of financial statements may not be worth it. Therefore, a cautionary statement, along the lines indicated below, should be included in the Explanatory Report to make clear that states should weigh the value of imposing specific accounting standards against barriers to entry.

Proposed Revision to Article 6(1)(M)(i)(c):

(M)(i)(c) audited or otherwise independently verified financial statement of the franchisor or affiliate of the franchisor that guarantees the obligations of the franchisor.

Proposed Revision to Explanatory Report:

The Model Law does not specify which state's accounting principles shall be used in preparing financial statements. A disclosure document conceivably could include financial statements prepared according to the accounting principles of the franchisee's state, the franchisor's state, or the state of the proposed franchised unit. Imposing specific accounting standards, however, may raise the franchisor's costs of conducting business, thereby discouraging expansion into new markets. A franchisor seeking to expand into a new market, for example, may have already expended substantial fees to have its financial statements audited in compliance with its home state's accounting principles. The additional cost of revising or preparing additional financial statements to satisfy a foreign state's accounting principles may be so high as to discourage many franchisors from offering new franchise opportunities there. . . At the same time, legislators may want to protect prospective investors from relying on financial reports which are difficult to understand or which present financial information in ways which differ materially from standard financial disclosures used in their home state. Therefore, when considering accounting standards, legislators should weigh the potential barriers to entry that imposing specific accounting principles might erect against the state's interest in facilitating access to franchise opportunities.

ARTICLE 6(2)(J) - INITIAL FEES**Background:**

This provision should be expanded to address refunds. A franchisor ought to specify when an initial fee is refundable.

Proposed Revision to Article 6(2)(J):

(J) the initial franchise fee, whether any portion of the fee is refundable, and the terms and conditions under which a refund will be granted.

ARTICLE 6(3) - SUB-FRANCHISOR INFORMATION**Background:**

Article 6(3) may result in prospective franchisees receiving outdated information from sub-franchisors. This can be addressed in the Explanatory Report.

Proposed Revision to Explanatory Report:

¶ 108: *Article 6 Paragraph (3)* specifically relates to the master franchise situation. . . . For this reason Paragraph (3) identifies those items of information which a prospective franchisee should receive as regards the franchisor, and states that the sub-franchisor must pass on this information that he/she has received from the franchisor to the prospective sub-franchisee. At the same time, the potential exists that such information from the sub-franchisor may be outdated and thus misleading. Accordingly, information passed on to the sub-franchisee should contain a specific date. Moreover, the subfranchisor should provide any known, updated information to the sub-franchisee. In addition, the sub-franchisor is required to inform the prospective sub-franchisee

FORUM SELECTION, CHOICE OF LAW, AND DISPUTE RESOLUTION

There is no provision in the Model Law regarding forum selection, choice of law, and dispute resolution (e.g., mandatory arbitration). This is a serious omission for a disclosure document, especially one used in international transactions.

Proposed New Paragraph – Article 6(2)(N):

(N) any forum selection or choice of law provisions, and any mandatory dispute resolution processes.

ARTICLE 9 – LANGUAGE**Background:**

Article 9 should permit greater flexibility regarding the language in which the disclosures must be drafted.

Proposed Revision to Article 9:

The disclosure document must be written in a clear and comprehensible manner in the official language of the principal place of business of the prospective

franchisee, unless the prospective franchisee agrees that it be written in the official language of its place of residence or domicile, or in the language principally used by the franchisor or by the franchisee in its business.

ARTICLE 10 - REMEDIES

Background:

Some concerns have been expressed that the remedies specified in Article 10 may not go far enough. Specifically, the remedies focus on termination, but do not expressly permit rescission. The Explanatory Report makes clear that the drafters avoided the term “rescission,” however, because that term has various meanings among the states. At the same time, the Explanatory Report suggests that the term “termination” may be broader than just ceasing to do business. Indeed, the text of the Model Law at Article 10(4) states that the right to terminate “does not derogate from any other rights that the franchisee may have.” The text could be clarified to make clear that any other remedies available under a state’s law would remain available.

Proposed Revision to Article 10:

(4) The right to terminate in accordance with paragraphs (1) and (2) of this Article does not derogate from any other right the franchisee may have under the applicable law, including seeking monetary redress.

ARTICLE 10(3)(A) - STATUTE OF LIMITATIONS

Background:

The one year Statute of Limitations is inadequate.

Proposed Revision to Article 10(3):

- (3)(A) three years after the act or omission constituting the breach upon which the right to terminate is based;
- (B) one year after the franchisee becomes aware of facts or circumstances reasonably indicating that it may have a claim for relief entitling the franchisee to terminate; or
- (C) ninety (90) days after the delivery to the franchisee of a written notice providing details of the breach accompanied by the franchisor’s then current disclosure document.

EXPLANATORY REPORT PARAGRAPH 36 - WAIVERS

Waiver by agreement of the parties or through choice of law is contrary to the purpose of the Model Law, to ensure that investors receive pre-sale disclosure in order to make an informed investment decision. This is especially true in international situations. This paragraph should be deleted.