

**Report of the Legislation Subcommittee**  
**of the**  
**Franchise, Distribution and Licensing Committee**  
**of the**  
**New York State Bar Association’s Business Law Section**  
**November 10, 2009**

Subcommittee Members:                    Thomas M. Pitegoff – Chair  
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***Background***

In a meeting on April 28, 2009, of the Franchise, Distribution and Licensing Committee (the “Committee”) of the New York State Bar Association’s Business Law Section, the Committee appointed a legislative subcommittee (the “Subcommittee”) to develop and recommend changes to the New York Franchise Act (GBL Article 33, §680 et seq.) and regulations. This is the Subcommittee’s report.

In January 2007, after years of study, the Federal Trade Commission issued a thoroughly revised trade regulation rule on franchising (16 CFR Part 436) (the “Amended FTC Rule” or the “Rule”), replacing the Commission’s 1978 franchise rule. The Amended FTC Rule, which became mandatory in July 2008, preempts inconsistent state laws except to the extent that the state laws afford prospective franchisees protection equal to or greater than the Amended FTC Rule.

The North American Securities Administrators Association (“NASAA”), comprised of representatives of the state authorities that administer state franchise laws, adopted the disclosure requirements of the Amended FTC Rule with minimal additional requirements when NASAA issued new NASAA Franchise Registration and Disclosure Guidelines effective in July 2008 (the “Amended NASAA Guidelines” or the “Guidelines”). The Amended NASAA Guidelines replaced the Uniform Franchise Offering Circular Guidelines that NASAA had adopted in 1993. The 1993 guidelines had replaced the original guidelines adopted in 1975 by the Midwest Securities Commissioners Association, NASAA’s predecessor.

Because the Amended FTC Rule substantially preempts the New York Franchise Act, the New York State Department of Law now accepts franchise disclosure documents for registration that follow the Amended FTC Rule and the Amended NASAA Guidelines, even though neither the Rule nor the Guidelines are reflected in the state law or regulations.

The Subcommittee drafted revisions to the New York Franchise Act to remove and revise the preempted requirements to be consistent with the requirements of the Amended FTC Rule. The Subcommittee made a number of other revisions intended to improve the law and to improve the legal environment for franchising in the state.

The Subcommittee also proposes that the Department of Law issue new regulations modeled after the Amended NASAA Guidelines. These new regulations would replace NYCRR, Title 13, Chapter VII, Part 200, dealing with franchise offerings. The Subcommittee recommends that the Department of Law issue these new regulations to become effective when the changes in the New York Franchise Act become effective.

Attached to this report is the text of the Subcommittee's proposed revised New York Franchise Act and regulations. The text of the revised Act is marked to show the changes from current law. The text of the regulations completely replaces Part 200 of the current regulations. Large portions of this text are essentially the same as the Amended NASAA Guidelines, with minimum revisions to fit in the context of the New York statutory and regulatory structure.

### ***Summary of the Proposed Changes***

Broadly speaking, the proposed changes accomplish several basic goals. First, the changes eliminate provisions of New York franchise law that are preempted by the Amended FTC Rule and replace them with provisions that restate the federal requirements. Second, the proposed changes align the scope of coverage of New York franchise law more closely with the franchise laws of other states, eliminating traps for the unwary and making New York a friendlier place to do business.

Specifically, the proposed Act and regulations together would accomplish the following significant improvements, among others:

- conform the required contents of a franchise disclosure document to the requirements of the Amended FTC Rule and the Amended NASAA Guidelines;
- conform the registration and disclosure procedures more closely to the Amended NASAA Guidelines and comparable requirements of the Amended FTC Rule;
- conform the definition of a franchise more closely to federal law and to the franchise laws of other states;
- remove the broker registration requirement;
- remove the requirements to file sales literature and to include a special NY disclaimer;
- remove the requirement of a franchisee to disclose on resale of the franchise; and

- add exemptions to conform to those of the Amended FTC Rule and the laws of other states, including offers and sales:
  - of franchises outside the U.S.;
  - of single master franchises within the state;
  - of franchises that require an initial investment of at least one million dollars;
  - of franchises to franchisees that have a net worth of at least five million dollars; and
  - of franchises to former franchisor insiders.

***Section by Section Analysis – Proposed Changes to GBL Article 33, §680 et seq.***

*Section 680 – Declaration of Policy*

Subsection (1) of the current law is an anachronism and is removed. Subsection (2) sufficiently and accurately reflects the Act’s intent and purpose.

*Section 681 – Definitions*

*Advertisement.* The definition of “advertisement” is updated to incorporate technologies that did not exist when the law was written.

*Fractional Franchise.* This definition is moved out of the regulations and made a part of the statute. The definition is the same as the definition of a “fractional franchise” under the Amended FTC Rule.

*Franchise.* The definition of “franchise” is substantially revised to conform closely to the definition of a “franchise” used in the Amended FTC Rule and the franchise laws of other states.

The current New York definition of a “franchise” is uniquely broad. Under current New York law, a business arrangement is a franchise if either (1) a party is granted the right to offer, sell or distribute goods or services under a marketing plan or system prescribed by a franchisor and the franchisee is required to pay a franchise fee or (2) a party is granted the right to offer, sell or distribute goods or services substantially associated with the franchisor’s advertising, trademark or certain other intellectual property rights designating the franchisor and the franchisee is required to pay a franchise fee. This bifurcated definition covers, for example, many licensing arrangements that were never intended to be covered by franchise law. New York now requires companies that would not be viewed as franchises in any other state to prepare extensive pre-sale disclosure documents and register their offerings with the state. This discourages some companies from doing business in New York. For others, the unexpectedly broad scope of the law acts as a trap for the unwary. It creates uncertainty, making compliance difficult.

*Franchisor.* This definition makes it clear that a franchise broker or area representative is not a franchisor because the franchisor actually signs the franchise agreement.

*Area Franchise.* This definition was deleted. It is unnecessary and describes a subfranchise or master franchise arrangement rather than an arrangement that is commonly understood today to be an “area franchise”.

*Franchise Fee.* This definition was deleted because its use resulted in a circular definition of a “franchise”. The specific list of payments that the current law lists as “not the payment of a franchise fee” were moved to a new Section 681.4(b) to accomplish the same purpose by stating that these payments do not constitute a “required payment” for purposes of the revised subsection 681.4(a), which defines a “franchise”. These transactions are taken from the current subsection 681.7.

*Franchise Sales Agent.* This definition was deleted. Franchise sales agents are more commonly referred to in the business as franchise brokers. Their obligations are included within the scope of the new definition of “franchise seller” below, which is similar to the same term in the Amended FTC Rule, and the new definition of a “franchise broker”.

*Franchise Seller.* This definition is new. It is the same definition used in the Amended FTC Rule. It replaces the prior term, “franchise sales agent”.

*Fraud.* In this definition and throughout the revised law, the term “disclosure document” is used in place of the word “prospectus” for the sake of conformity with the FTC Rule.

*Person.* This definition is expanded to include limited liability companies.

*Prospective Franchisee.* This definition is new. It is the same definition used in the Amended FTC Rule. This term is used throughout the Act, and this definition clarifies its meaning.

*Publish.* This definition is expanded to include electronic communications.

*Sale.* This definition now excludes the sale of a franchise by a franchisee for its own account when the franchisor plays no significant role in arranging for the sale. This is consistent with the laws of other states. The buyer can examine the operating history of the business and does not need to rely on the disclosure document unless the franchisor actively recruits to buyer or requires that the buyer sign a materially different form of franchise agreement.

*Subfranchisor.* This definition was revised for the sake of clarity.

#### *Section 682 – Scope*

This section replaces the same section of the current law in its entirety. This section of the current law adds nothing substantive to the law and no other state has an analogous provision.

#### *Section 683 – Registration and Disclosure Requirements*

Subsection 683.1 simply states that no person may offer or sell a franchise in New York unless the offer has been registered or is exempt.

The items required to be disclosed are contained in the revised regulations and no longer in subsection 683.2 of the statute.

The current subsections 683.5, 683.6 and 683.7 are renumbered (as 683.2, 683.3 and 683.4) and revised for consistency with the revised statutory structure and language.

New subsection 683.5 derives from California's "risk-based review" protocol. It is intended to optimize the review process by requiring franchise examiners to place greater focus on those applications that pose the greatest risk, such as new franchise offerings. With limited time available to a limited staff, this approach is designed to free up the time of regulatory personnel so that it can be devoted, for example, to investigating and prosecuting violations of the Act.

The new subsection 683.6 replaces the current subsection 683.8 and brings the disclosure timing requirements in line with the Amended FTC Rule. This new subsection (a) eliminates the "first personal meeting" disclosure trigger, (b) replaces the "ten business days" disclosure trigger with the "14 calendar days" trigger of the Amended FTC Rule, and (c) eliminates the requirement to furnish prospective franchisees with execution copies of the documents at least five business days before execution. This new provision also allows for electronic delivery of the disclosure document.

The current subsections 683.9 and 683.10 are renumbered (as 683.7 and 683.8) and revised for consistency with the revised statutory structure and language.

The requirements of the current subsections 683.11 and 12 to include specific language in franchise advertisements are removed. No other state has such requirements. New subsection 683.9 simply states that all advertising must be consistent with the information contained in the franchise disclosure document.

Current subsection 683.13 was deleted. This section is the broker registration requirement. This requirement is no longer necessary because the new definition of a "franchise seller", the proposed regulations would require franchisors to file franchise seller disclosure forms with respect to franchise brokers.

The current subsections 683.14 and 683.15 are renumbered (as 683.10 and 683.11).

#### *Section 684 – Exemptions*

Subsections 684.2 and 684.3(a) retain the exemption (or the right to seek an exemption) for franchisors with a high net worth, but they clarify that the exemption applies to the disclosure requirements as well as the registration requirements.

Subsection 684.3(c) retains the exemption for isolated sales, but removes the exclusion of offers to franchisees who will have the right to offer franchises to others. This change allows for the grant of a single master franchise to a New York company. Under current law, a foreign company that wants to enter the U.S. by granting national franchise rights to a single master

franchisee in New York would be required either (a) to prepare a disclosure document and seek franchise registration, or (b) seek a letter ruling from the Department of Law exempting the transaction from these requirements. This revised subsection 684.3(c) removes an impediment that foreign companies face in appointing master franchisees in New York. There is no policy reason that justifies the cost the foreign master franchisor must bear to prepare a disclosure document for a single, unique, highly negotiated transaction with a sophisticated business partner.

New paragraphs (e) through (l) of subsection 684.3 do the following:

- (e) This paragraph places the fractional franchise exemption in the law and removes it from the regulations. See also Section 681.3.
- (f) The leased department exemption conforms to the same exemption in the Amended FTC Rule and removes the need for former subsection 681.7(d).
- (g) The exemption for franchises governed by the Petroleum Marketing Practices Act appears in the Amended FTC Rule. The reference to Article 11-b is taken from the last sentence of Section 681.3 of the current law.
- (h) This exemption mirrors the new exemption in the Amended FTC Rule for investments of more than one million dollars.
- (i) This exemption mirrors the new exemption in the Amended FTC Rule for a franchisee with a high net worth.
- (j) This exemption is the same as the exemption in the Amended FTC Rule for franchisor insiders.
- (k) This paragraph introduces the \$500 threshold contained in the Amended FTC Rule. This allows for the removal of current subsection 681.7(e).
- (l) This paragraph exempts the sale of foreign franchise rights. This brings the geographic scope of the Act into line with the scope of the Amended FTC Rule. It also reduces the unnecessarily high cost of compliance for sales of franchise rights abroad, which are typically highly negotiated transactions involving sophisticated purchasers unique to the destination country.

Subsection 684.4 is deleted. This provision allows the Department of Law to deny or revoke an exemption in its discretion. The department's authority to impose requirements in its discretion that are contrary to the express language of an exemption undermines predictability and the public's ability to comply with the law. We know of no instance in which the Department of Law has ever invoked this provision.

Former subsection 684.5, now subsection 684.4, was revised for consistency with the Amended NASAA Guidelines. This revised subsection also eliminates the requirement that a franchise

owner who sells the franchise is required to furnish a disclosure document to the buyer. This requirement was difficult, if not impossible, for franchisees to meet, and was ignored in practice.

Former subsection 684.6 is now subsection 684.5.

*Section 685 – Escrows and Impoundments*

This section is unchanged, except that references to the “department of law” now use the term “department” which is defined in Section 681.2. This change was made throughout the revised statute.

*Section 686 – Designation of Department of Law as Agent for Service of Process; Service of Process*

This section is essentially unchanged except for the use of the defined term “franchise seller” and the term “franchise disclosure document” in place of “offering prospectus”.

*Section 687 – Fraudulent and Unlawful Practices*

This section contains new prohibitions that are the same as some of the specific prohibitions in the Amended FTC Rule and in other states.

*Section 688 – Investigations*

This section is unchanged except that it now uses the defined term “department”.

*Section 689 – Action by the Department of Law*

This section is unchanged except that it subsection 1 now uses the defined term “franchise seller” and refers to a ‘principal executive officer or director’ (as also used in Section 691.3) instead of a “principal”.

*Section 690 – Violations and Penalties*

This section is unchanged.

*Section 691 – Civil Remedies*

Subsection 691.1 corrects an apparent mistake in the current law. An immaterial and non-willful violation of the Act should give rise to the remedy of rescission; but, if the conduct is willful, the remedy should be damages. The current law states the remedies the other way around. The revised law also states that the interest rate is contained in the regulations.

Subsection 691.2 is unchanged except that the interest rate is now contained in the regulations.

*Section 692 – Enforcement by Attorney General*

This section is unchanged.

*Section 693 – Immunity*

This section is unchanged.

*Section 694 – Administration*

This section no longer states specific fees payable to the Department of Law. These will be in the revised regulations, which are far easier to amend.

*Section 695 – Separability Clause; Construction*

This section is unchanged.

***The New Regulations***

The proposed regulations attached to this report are largely the same as the Amended NASAA Guidelines. Sections 200.2 through 200.7 of the proposed regulations are essentially the Amended NASAA Guidelines, renumbered to replace portions of Part 200 of the current regulations. Part 201 of the current regulations, which are procedural regulations governing hearings held under the New York Franchise Act, would not be changed.

***The Current Regulations***

The new regulations would replace Part 200 of the current franchise regulations. The following comments refer to the numbered sections in the current regulations:

*200.1 Definitions*

This section defines a “franchise fee”, a “marketing plan”, a “predecessor” and a “principal”.

The definition of a “franchise fee” was deleted from Section 680 of the Act because its use resulted in a circular definition of a “franchise”. The Revised FTC Rule and the Revised NASAA Guidelines do not use the term “franchise fee”.

The definition of a “marketing plan” is also no longer necessary in light of the years of interpretation of that term under the franchise laws of several states. The term “marketing plan” is used in Section 681 of Act and is not used at all in the proposed regulations.

The term “predecessor” is defined in the Section 200.7 of the proposed regulations in the same manner as in the current Section 200.1.

The proposed Act and regulations do not use the term “principal” except in the context of the “principal executive officer”.

#### *200.2 Contents of Franchise Offering Prospectus*

The subject of the contents of the disclosure document is largely preempted by the Revised FTC Rule. The content requirements in the Revised NASAA Guidelines are the same as those under the Revised FTC Rule with the addition of a state cover page and other permitted state additions. These appear in Sections 200.3, 200.5 and 200.7 of the proposed regulations.

#### *200.3 Franchise Prospectus Registration Application*

The instructions for preparing the disclosure document appear in Section 200.4 of the proposed regulations. The forms are contained in Section 200.5.

Under the proposed regulations, it is no longer necessary to sign the application before a notary public. Most states do not require notarization of the application.

The language dealing with department action now appears in Section 200.2.E in a revised form.

The language dealing with sales pending amendment now appears in Section 200.2.F in a revised form.

#### *200.4 Rules Concerning Denial, Suspensions or Revocation of Franchise Sales Agent Registrations*

A shortened version of this section appears in the proposed regulations as Section 200.11(c).

#### *200.5 Amendments to Franchise Offering Prospectus*

The language dealing with amendments now appears in Section 200.4.B.

#### *200.6 Impoundment of Funds*

This Section is moved to Section 200.10.

#### *200.7 Rules Concerning Exemptions*

This section appears in a revised form as Section 200.12 of the proposed regulations.

#### *200.8 Annual Report Requirements*

This section appears in a revised form as Section 200.2.D of the proposed regulations.

### *200.9 Filing of Sales Literature*

This section was deleted from the proposed regulations. New York is one of only a few states that requires the filing of franchise sales literature. We know of no case in which the department of law has ever objected to franchise sales literature. This requirement appears to be a regulatory burden with no benefit to the public. The Department of Law retains the authority to issue regulations in the future to require the filing of sales literature under Section 683.12 of the proposed Act (Section 683.15 of the current Act).

### *200.10 Exemptions from Registration*

- (1) The reference to a form for a sale to an existing franchisee was deleted because such a sale can be included in the annual report under revised subsection 684.3(d) of the proposed Act and requires no special form.
- (2) The fractional franchise is exempted under revised subsection 684.3(e) of the proposed Act.
- (3) The fee for the filing of an exemption application is set forth in section 200.8(c) of the revised regulations.

### *200.11 Registration of Franchise Sales Agents*

This section was deleted. It is no longer necessary in light of the deletion of current Section 683.13 of the Act.

### *200.12 Exemption from Filing Requirements of Franchise Advertising on the Internet*

This section was deleted. It is no longer necessary in light of the deletion of current Section 200.9 of the regulations.

### *200.13 Franchise Regulations*

This section remains unchanged in substance, but contains minor revisions and it is renumbered as Section 200.12.

## ***The Proposed Regulations***

This section describes the differences between the proposed regulations and the Revised NASAA Guidelines, as well as the changes in the current law and regulations reflected in the proposed regulations.

### *200.2 Franchise Registration Application*

This section refers to initial franchise applications and applications for amendment. Consistent with past practice in New York, the registration is “amended” within 120 days after the end of each fiscal year with the new audited financials. This is the “annual report”.

200.2.D – This section describes the form of annual report in a manner specific to New York.

200.2.E – Department Action – This is a revised version of the current Section 200.3(h)(1).

200.2.F – Sales Pending Amendment – This is a revised version of the current Sections 200.3(h)(2) and (3).

### *200.3 The Franchise Disclosure Document*

This section presents the form of the cover page required by the Revised NASAA Guidelines.

### *200.4 Instructions for Preparation of the Franchise Disclosure Document*

200.4.A.9 – The three-year period of time to hold the documents is consistent with the statute of limitations and is a new provision. The Revised NASAA Guidelines refer generically to the applicable state law.

200.4.B – This section describes the requirements both for amendments and annual reports, replacing the current Section 200.5.

### *200.5 Forms*

These forms are already in use in New York as in the rest of the U.S., contrary to the language of the current law and regulations.

Form A does not require that the application be signed before a notary public. This changes the current requirement in New York. Most states do not require notarized applications.

Form E is a guarantee of performance to be used if the franchisor's parent or affiliate will be guaranteeing the franchisor's performance under the franchise agreement. The guarantee states that it continues in effect until all of the franchisor's obligations under the franchise agreement are satisfied or the franchisor's liability to its franchisees under the franchise agreement has been completely discharged. The attached regulations add this language:

“or until the Franchisor has been acquired, sold to, merged with or assigned to an entirely unaffiliated person or entity which expressly agrees to assume and discharge the functions of the Franchisor under the Franchise Agreement and is financially capable of doing so ....”

Public companies that own franchise companies commonly use the audited financial statements of the parent company in their franchise registrations, thereby agreeing to guaranty the obligations of their franchise subsidiaries. The added language allows the company to sell off a franchise subsidiary without incurring the inequitable result of guarantying previously issued franchise agreements for a period of years or even decades following the sale of the business.

### *200.6 Electronic Delivery of Franchise Disclosure Documents*

This section is NASAA's prescribed language explicitly permitting electronic disclosure. Current New York law does not address this issue.

### *200.7 Disclosure Requirements*

This section lays out the NASAA and FTC requirements with respect to the content of a franchise disclosure document.

The following definitions from the Revised NASAA Guidelines were not included in the proposed regulations because they appear in the proposed Act: Franchisee, Franchisor, Parent and Person.

Item 21 allows a start-up franchise system to phase in the use of audited financial statements. This is consistent with the Revised FTC Rule and contrary to the current New York requirement of audited financials from the outset. A startup in New York must have at least an audited opening balance sheet. While it would be possible under the Amended FTC Rule for New York to continue this requirement, it is doubtful that this requirement adds materially greater protection to franchisees or prospective franchisees.

Unlike current New York law, the new regulations do not require the inclusion of a separate page that states: "This disclosure document does not knowingly omit any material fact or contain any untrue statement of a material fact." While it would be possible under the Amended FTC Rule for New York to continue this requirement, no other state includes such a requirement in its franchise law and it is highly unlikely that it benefits franchisees or prospective franchisees in any way.

### *200.8 Filing Fees*

Section 694 of the current law states the fee for filing an application for franchise registration and the fee for filing an amendment. Section 200.8 of the proposed regulations moves the required fee amounts to the regulations and out of the Act. The fee for an exemption filing appears in Section 200.10(3) of the current regulations.

### *200.9 Interest Rate*

Sections 691.1 and 691.2 of the current law state the interest rate payable upon rescission. Section 200.9 of the proposed regulations moves the interest rate to the regulations and out of the Act.

### *200.10 Impoundment of Funds*

This Section is the same as Section 200.6 of the current regulations.

*200.11 Applications for Exemption*

This section allows the department of law to exercise its best judgment in determining what information should be required so that it may make a determination.

*200.12 Exemption for Franchise Advertising on the Internet*

This section is a slightly revised version of Section 200.13 of the current regulations.