

FINAL STATEMENT OF REASONS  
FOR RULE CHANGES UNDER THE  
FRANCHISE INVESTMENT LAW

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner (“Commissioner”) sets forth below the reasons for the amendment, adoption or repeal of Sections 310.114.1 and 310.156.3 of the California Code of Regulations (10 C.C.R. Sections 310.114.1 and 310.156.3).

Section 310.114.1 – The Offering Circular In General

Section 310.114.1(c)(5)(A)

Initially, the Department proposed an amendment to Section 310.114.1(c)(5)(A) of Title 10 of the California Code of Regulations (10 C.C.R. Section 310.114.1) that would require a franchisor to include the following statement in its offering circular: “Business and Professions Code Section 20040.5 relating to forum selection clauses restricting venue outside the state of California for arbitration may be preempted by the Federal Arbitration Act. Section 20040.5 may still apply to any provision relating to judicial proceedings.” The reason provided for the proposed amendment was to deter prospective franchisees from believing that binding arbitration clauses restricting a forum outside of California are automatically unenforceable under California Business and Professions Code Section 20040.5.

A commentor stated that the Department should not explain whether or not Business and Professions Code Section 20040.5 is enforceable in Section 310.114.1(c)(5)(A) because this provision concerns termination and non-renewal of a franchise. Another commentor, indicating that the proposed amendment did not provide an accurate statement of the law, recommended a revision. The Department finds that the proposed addition to Section 310.114.1(c)(5)(A) may be confusing and is not necessary. Thus, the Department deleted the proposed amendment to Section 310.114.1(c)(5)(A).

Section 310.114.1(c)(5)(B)(iv)

As originally proposed, Section 310.114.1(c)(5)(B)(iv) was modified to require franchisors to disclose that a binding arbitration provision “may not be enforceable under generally applicable contract defenses, such as fraud, duress, or unconscionability.” Originally, the disclosure required a statement that the “provision may not be enforceable under California law.” The reason provided for the proposed amendment was to prevent a prospective franchisee from mistakenly relying upon California Business Professions Code Section 20040.5 to overcome a binding arbitration clause restricting the forum to a location outside of the State of California. Furthermore, the amendment was proposed to avoid a court finding that an agreement to arbitrate is unenforceable on grounds that there was no “meeting of the minds” due to the required disclosure of Section 310.114.1(c)(5)(B)(iv).

Many commentors requested that the last sentence of Section 310.114.1(c)(5)(B)(iv) be deleted because it may not resolve the “meeting of the minds” problem created by Laxmi v. Golf USA (1999) 193 F.3d 1095, and may confuse prospective franchisees. Some commentors also thought the last sentence was unnecessary, and others argued that the required disclosure violates the Federal Arbitration Act. The Department agrees that the required disclosure may not resolve the “meeting of the minds” problem resulting in invalid arbitration provisions, and could be confusing to franchisees. As a result, the Department amended Section 310.114.1(c)(5)(B)(iv) to state, “Prospective franchisees are encouraged to consult private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California.” This amendment is necessary to protect franchisees who may mistakenly believe that there are no defenses to a binding arbitration provision. Furthermore, the Department finds this is the most effective means of preserving the disclosure that was originally intended for Section 310.114.1(c)(5)(B)(iv) without creating a “meeting of the minds” problem.

#### Section 310.114.1(c)(6)

The Department also proposed to add Section 310.114.1(c)(6) to require an additional disclosure by franchisors when making an earnings claim under Item 19 of the UFOC. The disclosure will require notice to prospective franchisees that the earnings claim does not include costs of sales, operating expenses, or other costs or expenses that must be deducted from gross revenue or gross sales figures to obtain net income or profit. The disclosure will only be required when a franchisor makes an earnings claim that does not include either costs of sales or expenses. The revision is necessary to resolve an ambiguity in Item 19 of the UFOC and to prevent franchisees from being misled by an earnings claim that does not include either costs or expenses.

#### Section 310.156.3 – Internet Advertisement Exemption

As originally proposed, the Department added Section 310.156.3 under Title 10 of the California Code of Regulations (10 C.C.R. Section 310.156.3) to provide an exemption for Internet advertisements from the filing requirements of Corporations Code Section 31156 subject to the following conditions:

1. The franchisor files a written verified notice with the Department, on an annual basis no later than December 31, that (a) discloses the Uniform Resource Locator (“URL”) address or similar address or device identifying the location of the Internet advertisement, (b) states that any Internet advertisement by the franchisor, or anyone acting with the franchisor’s knowledge, will comply with the FIL, and (c) provides the name, address, telephone number and contact person of the franchisor.

2. The Internet advertisement is not directed to any person in the State of California by or on behalf of the franchisor or anyone acting with the franchisor's knowledge.
3. The advertisement includes a statement in at least 12-point font that the website has not been reviewed or approved by the California Department of Corporations, and that any complaints concerning the content of the website may be directed to the Department.

Following the comment period, the Department revised Section 310.156.3 to modify and clarify the notice requirements. The Department made the following revisions:

- Section 310.156.3 was modified to clarify that the notice of exemption is valid from the date of its filing until the end of the franchisor's then-currently effective registration period. This revision was necessary to resolve an ambiguity in the proposed rule concerning the period of time the exemption was valid.
- The proposed rule was also modified to allow for renewal of the exemption at the same time of year that the franchisor's then-currently effective registration is subject to renewal. This revision was made in response to several comments received during the comment period, and was found to be necessary by the Department because it simplifies the notice requirement for franchisors.
- The Department changed Section 310.156.3 to permit the verified notice to be executed by an officer or general partner of the franchisor, instead of the Chief Executive Officer (CEO) of the franchisor. This revision was made to avoid an ambiguity in the rule for those franchisors that do not have a CEO, but still preserves the Department's interest in ensuring that the notice is reliable and credible.
- The proposed rule was also revised to require the verified notice to include a statement that the franchisor, or anyone acting with the franchisor's knowledge, agrees to comply with the California Franchise Investment Law, and the Rules thereunder, when posting an Internet advertisement on a website. The revision was made in response to several comments that the original provision required certification of a question or law, and was ambiguous because it did not relate to a specific date. The Department finds that this revision eliminates the ambiguity in the proposed rule, but continues to serve the purpose of ensuring an appropriate level of internal review by the franchisor.

- Because of some confusion concerning what was meant by “the Internet advertisement is not directed to any person in the State of California by or on behalf of the franchisor or anyone acting with the franchisor’s knowledge,” the proposed rule was modified. Under the rule, “directed to any person in the State of California,” means directed to a specifically named person, or group of persons, and not to the public generally, and includes, but is not limited to, non-passive forms of communication such as e-mail, instant messages, or other similar modes of communication.” The Department finds that this revision is necessary to eliminate confusion, and avoid abuse of the exemption, which is intended to prohibit direct communications such as e-mail, instant messages or other similar modes of communication.
- Originally, the proposed rule also required an Internet advertisement to state that the website has not been reviewed and approved by the Department, and that any complaints concerning the website may be directed to the Department. This provision was modified to require that the disclosure be included in the offering circular, as opposed to the website. This revision was made in response to comments that the required disclosure will result in state-specific clutter, and could result in complaints be directed to the Department by citizens of other states or countries. Although modified, the provision retains its purpose of providing notice to prospective franchisees that they need to carefully examine Internet advertisements, and providing complaint information to protect franchisees.

### ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for which the regulation is proposed or would be as effective and less burdensome to affected private persons than the adopted regulation.

### DETERMINATIONS

The Commissioner has determined that the adoption, amendment, or repeal of the regulation does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

Facts evidence, documents, testimony, or other evidence upon which the agency relies to support a finding that the action will not have a significant adverse economic impact on business, or would lessen any adverse economic impact on small business.

## ADDENDUM REGARDING PUBLIC COMMENTS

One request for public hearing was received on September 23, 2002 from Peter C. Lagarias. However, the request from Mr. Lagarias was withdrawn on October 7, 2002. No other request for hearing was received during the 45-day public comment period which ended on October 21, 2002. No public hearing was scheduled or heard.

### COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

Nine comment letters were received during the public comment period which ended on October 21, 2002. The comment letters are summarized below.

#### **COMMENTOR 1: The International Franchise Association (IFA) by letter dated October 17, 2002.**

COMMENT 1: The IFA indicates that it is inappropriate for Section 310.114.1(c)(5)(B)(iv) to single out arbitration clauses because the defenses of fraud, duress and unconscionability are applicable to all contract terms.

RESPONSE: The Department agrees that the defenses raised in the last sentence of Section 310.114.1(c)(5)(B)(iv) are applicable to all contract terms. Section 310.114.1(c)(5)(B)(iv) was revised and now reads, "Prospective franchisees are encouraged to consult private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California."

COMMENT 2: The IFA indicates that the last sentence of Section 310.114.1(c)(5)(B)(iv) will prevent a "meeting of the minds" and the enforceability of arbitration provisions, because of the disclosure's suggestion of unenforceability.

RESPONSE: The Department agrees that the last sentence of Section 310.114.1(c)(5)(B)(iv) may not resolve the "meeting of the minds" issue created by Laxmi. Section 310.114.1(c)(5)(B)(iv) was revised and now reads, "Prospective franchisees are encouraged to consult private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California."

COMMENT 3: The IFA suggests, for the purposes of clarity, that "either" should be added before "costs of sales or operating expenses" in Section 310.114.1(c)(6).

RESPONSE: The Department agrees with IFA's suggestion. Section 310.114.1(c)(6) was revised to add "either" before "costs of sales or operating expenses."

COMMENT 4: The IFA suggests, for the purposes of clarity, that “net” should be deleted before “income or profit” in Section 310.114.1(c)(6)

RESPONSE: Section 310.114.1(c)(6) was revised to state, “The earnings claims figure(s) does (do) not reflect costs of sales, operating expenses, or other costs or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit.”

COMMENT 5: The IFA indicates that it is inappropriate for Section 310.114.1(c)(B)(6) to require franchisors to state that franchisees and former franchisees may be the “best source” of cost and expenses data, because there is no proof that franchisees or former franchisees are in fact the best source.

RESPONSE: Section 310.114.1(c)(6) was revised to state, “You should conduct an independent investigation of the costs and expenses you will incur in operating your (franchised business). Franchisees or former franchisees, listed in the offering circular, may be one source of this information.”

COMMENT 6: The IFA recommends revision of 310.114.1(c)(6) to permit the disclosure to be made by a franchisor in either an addendum to the offering circular or in item 19.

RESPONSE: The Department agrees with the comment. Section 310.114.1(c)(6) was revised to permit the disclosure to be made in either a preface, exhibit or an appendix which is part of the offering circular, or in Item 19.

COMMENT 7: Concerning Section 310.114.1(c)(6), the IFA indicates that the information referenced in the disclosure is available in Item 20E and 20B, that such lists are rarely labeled with numbers, and that it would be preferable to omit the reference to 20B and refer to the offering circular instead.

RESPONSE: The Department agrees. Section 310.114.1(c)(6) was revised to reference that the information is available in the offering circular.

COMMENT 8: The IFA indicates that the Department has not identified any finding of fact or condition that supports Section 310.156.3. While IFA acknowledges the Department set forth administrative reasons that necessitate the requirements, IFA suggests that the Department is required to show that a finding of widespread fraud or a market condition supports the requirements.

RESPONSE: The Department disagrees with this comment. Section 31156 of the FIL provides the Commissioner with the authority to exempt any advertisement by rule from the filing requirement. Section 310.156.3 is not mandatory, but an option for franchisors desiring an exemption from Section 31156. As set forth in the Initial Statement of Reasons and the Final Statement of Reasons, the requirements are

necessary so that the Department may ensure compliance with the FIL and enable the Department to locate the advertisements for periodic monitoring.

COMMENT 9: The IFA suggests that Section 310.156.3 imposes an unnecessary burden on franchisors, who do not offer or sell franchises in California, and do not have a connection to California other than the fact that their websites can be viewed by Californians.

RESPONSE: The Department disagrees with this comment. Section 310.156.3 provides an exemption to Section 31156. Only if a franchisor were required to file its advertisements under Section 31156 would it be interested in the non-mandatory exemption provided by the rule. Because Section 31156 only applies to franchises subject to the registration requirements of the FIL, the rule does not place an unnecessary burden on franchisors that do not offer or sell franchises in the State of California. Furthermore Section 310.100.3 provides an exemption from the registration requirements of Section 31110 for the type of offers contemplated in IFA's comment.

COMMENT 10: The IFA indicates that the requirement that a certified statement be submitted to the Department imposes on some franchisors an obligation that would not otherwise apply.

RESPONSE: The Department disagrees with this comment. See the Department's response to IFA's Comment 9.

COMMENT 11: The IFA comments that Section 310.156.3 is inconsistent with Section 31013(c) of the FIL, which already exempts Internet advertisements from Section 31156 of the FIL.

RESPONSE: The Department disagrees with this comment. Section 31013(c) of the FIL provides an exemption for offers made in a publication with more than 2/3 of its circulation outside the state. This section applies to newspapers "or other publications of general, regular, and paid circulation." In addition, Section 31013(c) of the FIL provides that an offer to sell is not made in this state merely because "a radio or television program originating outside the state is received in this state." An Internet website is not a newspaper and does not necessarily have a general, regular or paid circulation. The Department also does not view Internet advertisements to be akin to radio and/or television. As a result, Section 31013(c) does not provide a general exemption for Internet advertisements.

COMMENT 12: The IFA recommends that the requirement of Section 310.156.3 that the franchisor's chief executive officer verify that the Internet advertisements comply with the FIL be deleted because it is unrealistic, and imposes a significant and unnecessary burden. As an alternative, IFA recommends that the verification come from the corporation and that the verification be given "to the best of my knowledge," and pursuant to a specified date.

RESPONSE: Section 310.156.3 was revised to require “a statement that the franchisor, or anyone acting with the franchisor’s knowledge, agrees to comply with the California Franchise Investment Law, and rules thereunder, when posting any Internet advertisement on a website.” In addition, Section 310.156.3 was revised to permit the verified statement to be executed by the franchisor through an officer or general partner of the franchisor.

COMMENT 13: The IFA indicates that Section 310.156.3 should be consistent with the NASAA exemption, and should not impose obligations beyond the NASAA exemption.

RESPONSE: The Department found that it was necessary to impose obligations beyond those set forth in the NASAA exemption. The Department is not under an obligation to adopt the NASAA model, and finds that the additional requirements set forth in the Section 310.156.3 are reasonably necessary. The additional requirements provide the Department with the information necessary to monitor the advertisements to ensure compliance with the FIL for the protection of franchisees, and do not impose unreasonable burdens on franchisors.

COMMENT 14: The IFA suggests that if there is to be an annual notice filing that it should be made on December 31 or upon renewal.

RESPONSE: Section 310.156.3 was revised to allow the renewal of the exemption to be made at the same time the franchisor seeks renewal of its registration.

COMMENT 15: The IFA indicates that the disclosure obligation set forth in Section 310.156.3 results in the implication that any website containing the disclosure is suspect. In addition, IFA states that it does not believe the Department made any finding of fraudulent activity that justifies the disclosure obligation.

RESPONSE: The Department agrees with this comment. Section 310.156.3 was revised to require that the disclosure be made in the offering circular.

COMMENT 16: The IFA indicates that the exemption may violate the Commerce Clause of the United States Constitution.

RESPONSE: The Department disagrees. As indicated in response to IFA’s comment number 9, Section 310.156.3 is limited in its application. Only those franchisees that are required to register their franchises with the Department would be interested in the exemption.

**COMMENTOR 2: Philip A. Kramer by letter dated October 18, 2002.**



COMMENT 1: Philip A. Kramer recommended that the Department refuse to register franchise offering circulars that contain out of state venue clauses, because the clauses violate the FIL and are against public policy.

RESPONSE: Because this comment is not specifically directed at the proposed regulations, the Department will not respond.

**COMMENTOR 3: The National Franchise Council (NFC) by letter dated October 21, 2002.**

COMMENT 1: The NFC suggests that the proposed amendment to Section 310.114.1(c)(5)(B)(iv) will not resolve the “meeting of the minds” issue raised by Laxmi, and, as a result, requests that the provision be deleted.

RESPONSE: The Department agrees that the last sentence of Section 310.114.1(c)(5)(B)(iv) may not resolve the “meeting of the minds” issue created by Laxmi. Section 310.114.1(c)(5)(B)(iv) was revised and now reads, “Prospective franchisees are encouraged to consult private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California.”

COMMENT 2: The NFC requests that “net” be deleted before income and profit in Section 310.114.1(c)(6).

RESPONSE: Section 310.114.1(c)(6) was revised to state, “The earnings claims figure(s) does (do) not reflect costs of sales, operating expenses, or other costs or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit.”

COMMENT 3: The NFC indicates that franchisees may not be the “best source” of costs and expense data as set forth in Section 310.114.1(c)(6), and requests that the sentence be revised.

RESPONSE: Section 310.114.1(c)(6) was revised to state, “You should conduct an independent investigation of the costs and expenses you will incur in operating your (franchised business). Franchisees or former franchisees, listed in the offering circular, may be one source of this information.”

COMMENT 4: The NFC comments that it is unwarranted for Section 310.156.3 to require CEO certification of a question of law. Instead, the certification should be made to the best of the franchisor’s knowledge and belief.

RESPONSE: Section 310.156.3 was revised to require “a statement that the franchisor, or anyone acting with the franchisor’s knowledge, agrees to comply with the

California Franchise Investment Law when posting any Internet advertisement on a website.” In addition, Section 310.156.3 was revised to permit the verified statement to be executed by the franchisor through an officer or general partner of the franchisor.

COMMENT 5: The NFC indicates that the CEO certification requirement of Section 310.156.3 is inconsistent with other provisions of the FIL, and suggests that the proposed rule be amended to permit the certification by “an officer or general partner of the applicant.”

RESPONSE: The Department concurs with this comment. Section 310.156.3 was revised to require “a statement that the franchisor, or anyone acting with the franchisor’s knowledge, agrees to comply with the California Franchise Investment Law, and rules thereunder, when posting any Internet advertisement on a website.” In addition, Section 310.156.3 was revised to permit the verified statement to be executed by the franchisor through an officer or general partner of the franchisor.

COMMENT 6: The NFC recommends that the disclosure requirement of Section 310.156.3 be deleted, because the website can be viewed outside of California. The NFC suggests that this may result in clutter and dilute the impact of more meaningful disclaimers. The NFC further indicates that the disclosures should be concentrated in the offering circular.

RESPONSE: The Department agrees with this comment. Section 310.156.3 was revised to require that the disclosure be made in the offering circular.

**COMMENTOR 4: American Association of Franchisees & Dealers (AAFD) by letter dated October 21, 2002.**

COMMENT 1: The AAFD recommends that before registering California franchisors, the Department should ensure that the franchisor included a venue clause that complies with Business and Professions Code Section 20040.5 of the California Franchise Relations Act. Furthermore, AAFD urged the Department to adopt a policy, rule or regulation to this effect.

RESPONSE: Because this comment is not specifically directed at the proposed regulations, the Department will not respond.

**COMMENTOR 5: Robin Day Glenn by letter dated October 21, 2002.**

COMMENT 1: Ms. Glenn indicates that the Department should not explain whether Business Code Section 20040.5 is enforceable in Section 310.114.1(c)(5)(A), because this provision was not intended to concern arbitration issues.

RESPONSE: The Department disagrees with this comment. However, Section 310.114.1(c)(5)(A) was revised to delete the proposed amendment.

COMMENT 2: Ms. Glenn recommends that the Department delete the caveat contained in the last sentence of Section 310.114.1(c)(5)(B)(iv), because it conflicts with the Federal Arbitration Act by burdening arbitration in a manner that it does not burden litigation. In addition, Ms. Glenn indicates that the proposed rule is likely to confuse and mislead prospective franchisees, and suggests that the arbitration provision is fraudulent, obtained by duress or unconscionable.

RESPONSE: The Department agrees that the last sentence of Section 310.114.1(c)(5)(B)(iv) may confuse and mislead prospective franchisees. Section 310.114.1(c)(5)(B)(iv) was revised and now reads, "Prospective franchisees are encouraged to consult private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California."

COMMENT 3: Ms. Glenn recommends that last sentence of Section 310.114.1(c)(6) be revised. Ms. Glenn states that franchisees are not the "best source" of cost and expense data as suggested in the proposed rule.

RESPONSE: Section 310.114.1(c)(6) was revised to state, "You should conduct an independent investigation of the costs and expenses you will incur in operating your (franchised business). Franchisees or former franchisees, listed in the offering circular, may be one source of this information."

COMMENT 4: Ms. Glenn suggests that Section 310.156.3 could be improved by requiring the annual certification at the time of a franchisor's annual registration renewal filing.

RESPONSE: The Department agrees. The proposed rule was revised to provide for renewal of the exemption at the same time the franchisor seeks renewal of its registration.

COMMENT 5: Ms. Glenn comments that Section 310.156.3 is confusing because "directed to any person in the State of California" is not defined. Ms. Glenn recommends that the provision be deleted or defined.

RESPONSE: The Department concurs. Section 310.156.3 was revised to clarify that "directed to any person in the State of California" means, "directed to a specifically named person, or group of persons, and not to the public generally, and includes, but is not limited to, non-passive forms of communication such as e-mail, instant messages, or other similar modes of communication."

COMMENT 6: Ms. Glenn suggests that the disclosure required in Section 310.156.3 should be made in the offering circular as opposed to the franchisor's website.

RESPONSE: The Department concurs with this comment. Section 310.156.3 was revised to require that the disclosure be made in the offering circular.

**COMMENTOR 6: Peter C. Lagarias by letter dated October 16, 2002.**

COMMENT 1: Peter C. Lagarias encourages the Department to adopt a rule that is consistent with Business and Professions Code Section 20040.5 of the California Franchise Relations Act, and refuse to register offering circulars that contain mandatory arbitration provisions providing for venue outside of California.

RESPONSE: Because this comment is not specifically directed at the proposed regulations, the Department will not respond.

COMMENT 2: Peter C. Lagarias recommends that the last sentence of proposed rule 310.114.1(c)(5)(A) be revised to state "Section 20040.5 applies to any provision relating to judicial proceedings." Peter C. Lagarias recommends the change because the proposed rule is inaccurate.

RESPONSE: The Department agrees that this disclosure may be confusing. Section 310.114.1(c)(5)(A) was revised by deleting the last sentence.

**COMMENTOR 7: Susan Grueneberg by letter dated October 21, 2002.**

COMMENT 1: Susan Grueneberg indicates that it may be preferable for the Department to revise Section 310.156.3 to permit franchisors to include their URL address on the cover page of the offering circular as permitted under NASAA's model regulation, instead of limiting the exemption to those who submit the verified notice.

RESPONSE: The Department disagrees with this comment. The Department found that the most effective means of implementing the exemption was to provide for a verified notice.

COMMENT 2: Susan Grueneberg indicates that the verified notice by the CEO required by Section 310.156.3 is unwarranted, because Section 31156 of the FIL does not contain such a requirement and submission of the URL to the Department already provides a means to ensure compliance with the FIL.

RESPONSE: The Department disagrees with this comment. However, Section 310.156.3 was revised to require "a statement that the franchisor, or anyone acting with the franchisor's knowledge, agrees to comply with the California Franchise Investment Law when posting any Internet advertisement on a website." In addition, Section 310.156.3 was revised to permit the verified statement to be executed by the franchisor through an officer or general partner of the franchisor.

COMMENT 3: Susan Grueneberg suggests that the disclosure required by Section 310.156.3 is not practical and should be deleted. In the alternative, Susan Grueneberg recommends that the exemption be amended to require a generic disclosure similar to the Internet offer exemption of Section 310.100.3.

RESPONSE: The Department revised Section 310.156.3 to require that the disclosure be made in the offering circular as opposed to the franchisor's Internet website.

**COMMENTOR 8: Judith M. Bailey by letter dated October 16, 2002.**

COMMENT 1: Judith M. Bailey recommends that Section 310.114.1(c)(5)(B)(iv) be revised to state "A franchise agreement provision requiring binding arbitration outside California with the costs to be borne by a specified party may not be enforceable under generally applicable contract defenses, such as fraud, duress, or unconscionability." Judith M. Bailey also recommends changes to other subsections of section 310.114.1. The reason provided for the revisions is that it permits the franchisor to prepare a generic state law addendum for all prospective franchisees.

RESPONSE: The Department disagrees with the recommended changes. However, Section 310.114.1(c)(5)(B)(iv) was revised, and now reads, "Prospective franchisees are encouraged to consult private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California."

COMMENT 2: Judith M. Bailey recommends that the reference made in Section 310.114.1(c)(6) be revised to refer to Item "20" instead of "20B."

RESPONSE: The Department concurs with this comment. Section 310.114.1(c)(6) was revised to refer to the offering circular, and now states, "Franchisees or former franchisees, listed in the offering circular, may be one source of this information."

COMMENT 3: Judith M. Bailey requests that Section 310.156.3 be revised to permit a generic disclosure, rather than one specific to California. The reason set forth for the change is to avoid the necessity of a franchisor including a "number of confusing messages" that would take up a significant amount of space on a franchisors' website.

RESPONSE: The Department concurs with this comment. Section 310.156.3 was revised to require the disclosure to be made in the offering circular, instead of the Internet website.

COMMENT 4: Judith M. Bailey also recommended, without an explanation, a revision to Section 310.156.3(b).

RESPONSE: The Department disagrees that a revision to Section 310.156.3(b) is necessary. Section 310.156.3(b) merely provides notice and clarification to franchisors that the exemption does not limit the Commissioner's authority to bring an action against any person violating the provisions of the FIL.

**COMMENTOR 9: The Franchise Law Committee (FLC) of the California State Bar by three letters dated October 15, 2002, October 17, 2002 and October 17, 2002.**

COMMENT 1: The FLC recommends that the last sentence of Section 310.114.1(c)(5)(B)(iv) be deleted because it does not resolve the "meetings of the minds" issue created by Laxmi and may create additional confusion or problems. Furthermore, the FLC indicates that the last sentence is unnecessary

RESPONSE: The Department agrees that the last sentence of Section 310.114.1(c)(5)(B)(iv) may not resolve the "meeting of the minds" issue created by Laxmi. Section 310.114.1(c)(5)(B)(iv) was revised and now reads, "Prospective franchisees are encouraged to consult private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California." =

COMMENT 2: The FLC argues that the CEO certification requirement of Section 310.156.3(a) should be deleted because there is no precedent supporting the requirement. Furthermore, the FLC argues that the section requires verification of a question of law, will not prevent fraud, and is unnecessary.

RESPONSE: Section 310.156.3 was revised so that it no longer requires certification of a question of law, but mandates an agreement by the franchisor, or anyone acting with the franchisor's knowledge, to comply with the FIL when posting an advertisement on a website.

COMMENT 3: The FLC recommends that Section 310.156.3 be revised to permit filing of the verified notice at the time of renewal of the franchisor's registration.

RESPONSE: The Department agrees. Section 310.156.3 was revised to incorporate this comment.

COMMENT 4: The FLC recommends that Section 310.156.3 be revised to permit any authorized agent of the franchisor to make the verified notice, because not all franchisors have a CEO.

RESPONSE: The Department concurs with this comment. Section 310.156.3 was revised to permit the verified notice to be made by an officer or general partner of the franchisor.

COMMENT 5: The FLC recommends that the verified notice requirement of Section 310.156.3 should be limited to Internet Advertisements of a specific date, and should not include past or future Internet advertisements. Furthermore, the FLC recommends that the certification be made to the best of the franchisor's knowledge and belief.

RESPONSE: Section 310.156.3 was revised to require "a statement that the franchisor, or anyone acting with the franchisor's knowledge, agrees to comply with the California Franchise Investment Law when posting any Internet advertisement on a website."

COMMENT 6: The FLC indicates that for the purposes of clarity the word "either" should be added before "costs of sales or operating expenses" in Section 310.114.1(c)(6).

RESPONSE: The Department agrees with this comment. Section 310.114.1(c)(6) was revised to incorporate this comment.

COMMENT 7: The FLC recommends that Section 310.114.1(c)(6) be revised to permit the disclosure to be made in the body of Item 19 or in an addendum or appendix to the offering circular.

RESPONSE: The Department agrees with this comment. Section 310.114.1(c)(6) was revised to incorporate this comment.

COMMENT 8: The FLC requests clarification concerning whether or not Section 310.114.1(c)(6) permits an Item 19 disclosure to be made without the disclosure if "any cost or expense data is included" in the Item 19 disclosure.

RESPONSE: The Department disagrees with the FLC's interpretation of Section 310.114.1(c)(6), and does not find that Section 310.114.1(c)(6) needs to be modified. The proposed rule requires the disclosure if an earnings claim does not include either costs of sales or operating expenses.

COMMENT 9: The FLC recommends deletion of the word "net" before "income or profit" because additional factors must be deleted from gross revenues or gross sales in order to arrive at net income or profit.

RESPONSE: The Department concurs with this comment. Section 310.114.1(c)(6) was revised to incorporate this comment, and now states, "The earning claims figure(s) does (do) not reflect costs of sales, operating expenses, or other costs

or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit."

COMMENT 10: The FLC indicates that franchisees are not the "best source" of cost and expense data. As a result, the FLC argues that the reference made in the disclosure should be deleted.

RESPONSE: Section 310.114.1(c)(6) was revised to state, "You should conduct an independent investigation of the costs and expenses you will incur in operating your (franchised business). Franchisees or former franchisees, listed in the offering circular, may be one source of this information."

COMMENT 11: The FLC recommends that the reference to "20B" be revised to "20" because items are not sub-numbered in the offering circular.

RESPONSE: The Department concurs with this comment. Section 310.114.1(c)(6) was revised to eliminate this reference and now states, "You should conduct an independent investigation of the costs and expenses you will incur in operating your (franchised business). Franchisees or former franchisees, listed in the offering circular, may be one source of this information."

#### COMMENTS RECEIVED DURING THE SUBSEQUENT 15-DAY PERIOD ENDING FEBRUARY 24, 2003

Three comment letters were received during the subsequent 15-day public comment period which ended on February 24, 2003. The comment letters are summarized below.

#### **COMMENTOR 1: Peter C. Lagarias by letter dated February 21, 2003.**

COMMENT 1: Peter C. Lagarias expressed his dissatisfaction with the use of the word "may" in Section 310.114.1(B)(ii) to describe whether or not a covenant not to compete provision is enforceable under California Law.

RESPONSE: Because this comment is not specifically directed at the proposed regulations, the Department will not respond.

COMMENT 2: Peter C. Lagarias comments that the proposed amendment to Section 310.114.1(c)(5)(B)(iv) will eliminate protections provided to franchisees in the case of Laxmi v. Golf USA (1999) 193 F.3d 1095.

RESPONSE: The Department found it necessary to amend Section 310.114.1(c)(5)(B)(iv) because this section was not intended to void an agreement between a franchisor or franchisee concerning the location of binding arbitration on grounds that there was no meeting of the minds as the court concluded in Laxmi v. Golf USA (1999) 193 F.3d 1095.



COMMENT 3: Peter C. Lagarias states that that the Department should follow Business & Professions Code Section 20040.5, and refuse to register offering circulars which include out of state venue clauses.

RESPONSE: Because this comment is not specifically directed at the proposed regulations, the Department will not respond.

COMMENT 4: Peter C. Lagarias suggests that the disclosure statement that “you should conduct an independent investigation” required by Section 310.114(c)(6) will be used by franchisors to argue that fraud did not occur.

RESPONSE: The Department finds that it is necessary to require that the disclosure be made when a franchisor makes an earnings claim that does not include either costs of sales or operating expenses. While the disclosure may impair a franchisor’s ability to argue in subsequent litigation that a gross only earnings claim was fraudulent, the Department finds that it is more important for the disclosure to be made up-front to prevent franchisees from being misled.

COMMENT 5: Peter C. Lagarias requests that the Department promulgate a rule stating that representation clauses and no reliance clauses in offering circulars and appended franchise agreements are void under Corporations Code Section 31512 as "violative" of the anti-waiver rule. In the alternative, Peter C. Lagarias comments that the Department should refuse to register franchise agreements with language that violates the anti-waiver rule.

RESPONSE: Because this comment is not specifically directed at the proposed regulations, the Department will not respond.

COMMENT 6: Peter C. Lagarias suggests that the Department should require a franchisor to file a copy of its website advertisement with the Department once the franchisor has entered into a franchise agreement with a California resident.

RESPONSE: Arguably, this comment is not specifically directed at the proposed regulation. Rule 310.156.3 provides an exemption to the filing requirements of Section 31156 for filing advertisements with the Commissioner. As a result, Internet advertisements, including a franchisor's website, would not be required to be filed with the Department for the reasons set forth in the Initial Statement of Reasons. Imposing the requirement suggested by Peter C. Lagarias takes an opposite approach from the rulemaking and the Department finds it unnecessary because Rule 310.156.3 requires a franchisor seeking the exemption to provide the Department with the uniform resource locator (URL) of any of Internet advertisement. The franchisor also must provide the URL address in its UFOC, thereby permitting the website to be patrolled by the marketplace and the Department.

**COMMENTOR 2: Franchise Law Committee (FLC) by letter dated February 20, 2003.**

COMMENT 1: The FLC recommends that the word “exhibit” be added to the phrase “preface or appendix” used throughout rule 310.114.1 to incorporate terminology that is commonly used by both franchisors and their counsel to describe documents attached to offering circulars.

RESPONSE: The Department made a clarifying change to Section 310.156(a)(3) to implement this comment.

COMMENT 2: Concerning Section 310.156.3(a)(2), the FLC comments, that the physical presence of the recipient is, or should be, irrelevant. The FLC further states that it views the proposed rule as triggering an unintended violation for non-Californians who may receive an email while visiting California.

RESPONSE: The Department disagrees with the suggested revision. Section 310.156.3 only exempts Internet advertisements that are “posted on a website on the Internet,” it does not exempt advertising in the form of emails. Rather, advertising by email is a form of direct communication, which is exactly what is prohibited by Section 310.156.3(a)(2).

COMMENT 3: The FLC suggests that “used in this State,” or similar language, should be added to Section 310.156.3(a)(3) after “franchisor’s offering circular.”

RESPONSE: The Department finds that the suggested revision is not necessary. The scope of Section 310.156.3 is limited to franchisors who are required to register under the FIL. As provided in Corporations Code Section 31110, if a franchisor is not offering or selling franchises in California, it is not required to register with the Department and would not be interested in the exemption provided by Section 310.156.3. As for franchisors that are registered in California and in other states, Section 310.156.3(a)(3) is limited to the franchisor’s California offering circular.

COMMENT 4: The FLC recommends that the phrase “then-currently effective” or similar language be inserted in the first and second sentences of Section 310.156.3(b) after “the franchisor’s offering circular.”

RESPONSE: The Department made a clarifying change to Section 310.156.3(b) to implement this comment.

COMMENT 5: The FLC recommends that the phrase "for additional period of one year" be deleted from Section 310.156.3(b), and that a sentence be added to specify the renewal notice effective dates.

RESPONSE: The Department made a clarifying change to Section 310.156.3(b), to resolve this comment. Section 310.156.3(b) now reads, "The exemption may be renewed for additional periods of one year by submitting to the Commissioner no later than the end of the franchisor’s then-currently effective registration period, as specified

in Section 310.120, an additional written notice that complies with the requirements of subsection (a)."

**COMMENTOR 3: International Franchise Association (IFA) by letter dated February 24, 2003.**

COMMENT 1: The IFA recommends revisions to Section 310.114.1(c)(3) to permit a franchisor to state once on the cover page, or at the beginning of the offering circular, instead of in Item 17 and Item 19, that "additional information regarding California requirements is included in the appendix attached to the circular."

RESPONSE: The Department rejects this recommendation, because it finds it necessary, for the protection of franchisees, to require franchisors to reference in the relevant item that additional information is available.

COMMENT 2: The IFA suggests that the second sentence of Section 310.114.1(c)(5)(B)(iv) stating, "The arbitration will occur at (indicate sites) with the costs being borne by (explanation)" should be deleted because it is unnecessary and repetitive.

RESPONSE: The Department disagrees with this comment. NASAA's Uniform Franchise Offering Circular Guidelines, concerning the cover page, do not include requirements concerning binding arbitration or the party who will bear the costs of arbitration. As a result, the Department finds the additional disclosure unnecessary, and not a repetition of existing requirements.

COMMENT 3: The IFA offers additional language to Section 310.156.3(a) to clarify that the exemption only applies to franchisors subject to the California Franchise Investment Law.

RESPONSE: The Department disagrees with this comment. The clarifying language is not necessary. Whether or not a franchisor would like to take advantage of the exemption by satisfying the requirements is an option, not a requirement. Furthermore, a franchisor that is not subject to the registration requirements of the FIL would not be interested in the exemption, because they are already exempt by the language of Section 31156.

COMMENT 4: The IFA comments that the Department should add language to Section 310.156.3 to specifically set forth what provisions of the FIL a franchisor must comply with in order to satisfy the requirement of Section 310.156.3(a)(1)(B).

RESPONSE: The Department disagrees with this comment. The Department does not find that it is necessary to specify certain provisions, as the Department intended that a franchisor comply with all relevant provisions of the FIL, and Rules thereunder, when posting an Internet advertisement on a website.

COMMENT 5: The IFA suggests that the Department add a knowledge standard to Section 310.156.3(a)(2).

RESPONSE: The Department disagrees with this comment, finding that a knowledge standard is not necessary. Section 310.156.3 only exempts Internet advertisements that are “posted on a website on the Internet,” it does not exempt advertising in the form of emails. Rather, advertising by email is a form of direct communication, which is exactly what is prohibited by Section 310.156.3(a)(2).

COMMENT 6: The IFA comments that it would be helpful for the Commissioner to explain in Section 310.156.3 that the Commissioner will not exercise jurisdiction over franchisors who are not registered in California.

RESPONSE: The Department disagrees with the suggested revision. The Department does not find it necessary to explain that franchisors who are not subject to the registration requirements of the FIL would not be interested in the non-mandatory exemption provided by Section 310.156.3.

COMMENT 7: The IFA recommends that the Department add additional language to Section 310.156.3(a)(3) to clarify that the disclosure should be made in the preface or appendix to the offering circular.

RESPONSE: The Department made a clarifying change to Section 310.156(a)(3) to implement this comment.

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