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## THE PROPOSED REVISED FRANCHISE RULE WILL NOT CLARIFY THE CONFUSION AS TO THE EXTRATERRITORIAL SCOPE OF THE RULE

*Jessica Lynn Kruse*<sup>†</sup>

### I. INTRODUCTION

The world of franchising<sup>1</sup> looks very different from when the concept first emerged in the 1950s.<sup>2</sup> When it promulgated the Franchise Rule in 1979, the Federal Trade Commission (FTC) could not have imagined a global business environment such as this.<sup>3</sup> Since the Franchise Rule first took effect a movement to update the Rule to accommodate the changing landscape has

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† B.A. 2003 Summa Cum Laude, Southwest Missouri State University, Springfield, Missouri; J.D. Candidate 2006, University of Tulsa College of Law, Tulsa Oklahoma. I would like to dedicate this comment to my husband Jason, my daughter Lilly, and my parents Janice and Vernon Overman who have made many sacrifices and provided constant encouragement to help me succeed. I would also like to recognize the ILJ Editorial Board and Staff for their dedication and hard work in making this publication possible.

1. Franchising is a scheme involving distribution and sale of products and usually contains restrictions on the franchisee regarding what, how, and where products can be sold. Franchising is regulated due to the restrictive nature of the competitive relationship. There are many different kinds of franchises. First, in the industrial franchise, the franchisor gives instructions on how to manufacture a product under which the franchisee sells the products using the franchisor's trademark. Second, in the service franchise, the franchisor directs the franchisee on how to perform a service, and the franchisee performs this service under the franchisor's name or trademark. Finally, the most common type of franchise is the distribution franchise, in which the franchisee sells products under the franchisor's name in a retail store, allowing the franchisee to use the franchisor's commercial methods. *NEGOTIATING AND STRUCTURING INTERNATIONAL COMMERCIAL TRANSACTIONS* 20 (Mark R. Sandstrom & David N. Goldsweig eds., 2d ed. 2003).

2. See *FUNDAMENTALS OF INTERNATIONAL FRANCHISING* xi (Richard M. Asbill & Steven M. Goldman eds., 2001) [hereinafter *INTERNATIONAL FRANCHISING*].

3. See *BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION, DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING: STAFF REPORT TO THE FEDERAL TRADE COMMISSION AND PROPOSED REVISED TRADE REGULATION RULE* (proposed Aug. 2004) (to be codified at 16 C.F.R. pt. 436), available at <http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf> (last visited Mar. 1, 2005) [hereinafter *STAFF REPORT*].

occurred.<sup>4</sup> In August 2004, the FTC issued a staff report with suggestions on how to overhaul the current Franchise Rule;<sup>5</sup> specifically, the staff report suggested that the scope of the Franchise Rule be limited to domestic transactions only.<sup>6</sup> Although this has been the informal position of the FTC since the rule was promulgated, the courts have not been clear on what this really means.<sup>7</sup>

The Franchise Rule lays out the form and content of the disclosures that the franchisor has to make to the franchisee,<sup>8</sup> and deems failure to make proper disclosures an unfair or deceptive act or practice;<sup>9</sup> if a violation is discovered, the FTC "shall be liable for a civil penalty of not more than \$10,000 for each violation."<sup>10</sup> Some of the required disclosures in the Uniform Franchise Offering Circular (UFOC) include information about: (1) the parent company, including past business experience, criminal record of the franchisor, and lawsuits that have been or are currently pending against the franchisor or the parent company; (2) the franchise to be sold, including a factual description of the franchise, the funds that the franchisee will have to pay to the franchisor, and an estimate of the total amount of money that the potential franchisee will have to pay; and (3) the terms of the agreement between the franchisor and franchisee.<sup>11</sup>

Many factors need to be taken into account in order to clarify the Franchise Rule's scope.<sup>12</sup> The first factor involves the type of transaction that is taking place.<sup>13</sup> Although all transactions that fall under the scope of the Franchise Rule involve a U.S. franchisor, the franchisee could be a U.S. citizen wanting to place a franchise abroad or a foreign citizen wanting to place the franchise in his or her home country.<sup>14</sup>

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4. *Id.*

5. *Id.*

6. *Id.* at 72.

7. See Kenneth R. Costello, Loeb & Loeb, L.L.P., *Comment 63, #17 Public Workshops: Franchise Rulemaking (07/97)*, FEDERAL TRADE COMMISSION, Apr. 30, 1997, at <http://www.ftc.gov/bcp/franchise/comments/costel63.htm> (last visited Mar. 1, 2005).

8. Request for Comments Concerning Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 60 Fed. Reg. 17,656 (proposed April 7, 1995) (to be codified at 16 C.F.R. pt. 436) [hereinafter 1995 NPR].

9. See *id.*

10. 15 U.S.C. § 45(m)(1)(A).

11. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.1 (1978).

12. See generally John R. F. Baer et al., *Application of U.S. Franchise Laws to International Franchise Sales*, 15 FALL FRANCHISE L.J. 41 (1995).

13. *Id.* at 62.

14. *Id.* at 63.

Second, the extraterritorial application<sup>15</sup> of the Franchise Rule is problematic for several reasons.<sup>16</sup> First, requiring U.S. franchisors to develop separate UFOCs for each country in which they plan to develop franchises would be unduly burdensome, and often irrelevant to foreign franchise transactions.<sup>17</sup> Second, the underlying purpose of the Franchise Rule, to disclose relevant information to the franchisee so that the franchisee will be able to make an informed business decision, would not be met.<sup>18</sup> The International Franchise Association (IFA) submits that the prospective international franchisee does not need the protection of franchise laws in the United States since the Franchise Rule was developed to protect the “mom and pop” investor who may not know much about investing in a company.<sup>19</sup> The IFA finds that the foreign investor, who is seeking a relationship with a U.S. franchisor, is more sophisticated since international franchise agreements expect this of a master franchisee or national developer.<sup>20</sup> Foreign franchisees are often more knowledgeable about conditions in their country that will affect the franchise and typically have very

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15. When referring to extraterritorial application of U.S. law, this means the prescriptive jurisdiction of U.S. courts. This occurs when the conduct occurs in the United States, yet the effects occur in other countries; the conduct occurs in other countries, yet the effects occur within the U.S.; and finally, when both the conduct and the effects occur in another country. Afshin Atabaki, *Extraterritorial Prescriptive Jurisdiction*, 34 INT’L LAW. 564, 564 n.157 (2000).

16. Terry W. Schackmann & Clayton L. Barker, *The FTC Act and the Franchise Disclosure Rule in Nieman v. Dryclean U.S.A. Franchise Company*, 18 FRANCHISE L.J. 108, 113 (1999).

17. *Id.*

18. *Id.*

19. Matthew R. Shay, International Franchise Association, *Comment 82, #17 Public Workshops: Franchise Rulemaking (07/97)*, FEDERAL TRADE COMMISSION, May 16, 1997, at <http://www.ftc.gov/bcp/franchise/comments/82shay.htm> (last visited Mar. 2, 2005) [hereinafter *Comment 82*]. The IFA is an association that includes both franchisors and franchisees, founded in 1960 in order to serve as a resource center and represent “the interests of franchising before legislatures, courts, and the press.” Brief of Amicus Curiae The International Franchise Association at 2, *Nieman v. Dryclean U.S.A. Franchise Co.*, 178 F.3d 1126 (11th Cir. 1999) (No. 97-4745) [hereinafter IFA’s Brief]. Their constituents include “800 franchisors, 1,000 individual member franchisees and 28,000 franchisees affiliated with the 45 franchise association members of the IFA.” Not only do they represent the franchisors and franchisees, but they also represent over 300 service and product suppliers to the franchise groups. The association works with both domestic and international policy makers in order to protect the interests of both franchisors and franchisees and to promote franchise growth. This includes being heavily involved in the promulgation of the original Franchise Rule in 1978. The comments that were submitted by the IFA were the result of many discussions among the constituents of the IFA, and were reviewed “by the IFA Executive Committee, Board of Directors, Franchisee Advisory Council and Corporate Counsel Committee, among others.” Matthew R. Shay, International Franchise Association, *Comment 22, #3 16 CFR Part 436*, FEDERAL TRADE COMMISSION, Dec. 21, 1999, at <http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment022.htm> (last visited Mar. 2, 2005) [hereinafter *Comment 22*].

20. IFA’s Brief at 8, *Nieman* (no. 97-4745).

large and diverse business organizations; therefore they have the capital, expertise, and means to investigate the U.S. franchise before entering into the relationship.<sup>21</sup>

If there is a potential foreign franchisee, who is not as sophisticated as those investors described above, the individual countries can enact franchise pre-sale disclosure laws.<sup>22</sup> Parts of Canada, France, Australia, Mexico, Brazil, Spain, Indonesia, and Russia have already enacted legislation that requires pre-sale disclosure on behalf of franchisors to potential franchisees.<sup>23</sup> This indicates that other countries are capable of protecting franchisees in their own country.<sup>24</sup>

After considering these factors, the proposed clarifications to the Franchise Rule, found in the staff report, will not be adequate to address all of these concerns.<sup>25</sup> In essence, the staff report suggests adding only the phrase "in the United States of America, its territories, or possessions."<sup>26</sup> If this wording is implemented, questions will still exist as to whether this means that negotiations need to take place in the United States, or if this means the franchise needs to be located in the United States.<sup>27</sup> Therefore, the FTC should further clarify the extraterritorial application of the Franchise Rule.<sup>28</sup>

This article will discuss the current wording relevant to the extraterritorial scope of the Franchise Rule.<sup>29</sup> Despite the supposed intentions of the FTC to apply the Franchise Rule to strictly domestic transactions, the current language does not clearly reflect this intention.<sup>30</sup> Therefore, confusion exists among franchisors as to the transactions in which they are required to provide disclosures.<sup>31</sup> Additionally, the article will explain the background to the Franchise Rule changes, including the proposed changes to limit the scope of the

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21. *Id.*

22. *Id.* at 20.

23. *Id.*

24. *Id.* at 21.

25. See generally STAFF REPORT, *supra* note 3.

26. See *id.* at Attach. B, p.7.

27. See L. Seth Stadfeld, *Comment 23, #3 16 CFR Part 436: Franchise Rule Review*, FEDERAL TRADE COMMISSION, Dec. 21, 1999, at

<http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment023.htm> (last visited Mar. 2, 2005); AFC Enterprises, *Comment 30, #3 16 CFR Part 436: Franchise Rule Review*, FEDERAL TRADE COMMISSION, Dec. 20, 1999, at

<http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment030.htm> (last visited Mar. 2, 2005); John R.F. Baer, *Comment 25, #17 Public Workshop: Franchise Rulemaking (07/97)*, FEDERAL TRADE COMMISSION May 11, 1997, at

<http://www.ftc.gov/bcp/franchise/comments/baer25.htm> (last visited Jan. 31, 2005).

28. See STAFF REPORT, *supra* note 3, at 72.

29. See generally *id.*

30. 16 C.F.R. § 436.1.

31. See IFA's Brief at 8, *Nieman* (no. 97-4745).

Franchise Rule to domestic transactions.<sup>32</sup> Next, this article will cover the two tests the courts have developed to limit the scope of the FTC's definition of "commerce" to domestic transactions and show that the "conduct-effects test" and the "presumption against extraterritoriality test," developed in the district courts, have only added to the existing confusion.<sup>33</sup> Finally, comments on the proposed language indicating the change that is supposed to limit the scope to domestic transactions will be analyzed.<sup>34</sup> The development of the Franchise Rule will be compared to similar developments that took place when the Securities and Exchange Commission (SEC) revised the scope of the disclosure requirements in the sale of securities.<sup>35</sup> The conclusion will address the similar changes that need to occur to the Franchise Rule in order to limit the confusion that exists regarding transactions and the disclosure requirements' application.<sup>36</sup>

## II. THE PROPOSED REVISED FRANCHISE RULE ATTEMPTS TO CLARIFY THE LIMITATIONS TO THE EXTRATERRITORIAL SCOPE AS REFLECTED IN THE POLICY OF THE FTC

### A. Current Wording of The Franchise Rule (16 C.F.R. 436.1)

The current Franchise Rule does not explicitly exclude international transactions from the requirement of disclosure by U.S. franchisors.<sup>37</sup> In fact, a literal reading of the Franchise Rule would indicate the opposite.<sup>38</sup> The relevant wording of the FTC Franchise Rule (Franchise Rule) is found in 16 C.F.R. § 436.1.<sup>39</sup> This section defines the purpose and scope of the Franchise Rule "[i]n connection with the advertising, offering, licensing, contracting, sale, or other promotion in or affecting commerce, as 'commerce' is defined in the Federal Trade Commission Act, of any franchise, or any relationship which is

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32. See generally STAFF REPORT, *supra* note 3, at Attach. B, p.7.

33. See Baer, *supra* note 12, at 62 (providing a discussion of the effects test); see also Nieman v. Dryclean U.S.A. Franchise Co., 178 F.3d 1126 (11th Cir. 1999); Branch v. Fed. Trade Comm'n, 141 F.2d 31 (7th Cir. 1944).

34. See #133 16 C.F.R. Part 436; FTC Matter No. R511003: Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report of the Bureau of Consumer Protection to the Federal Trade Commission and Proposed Revised Trade Regulation Rule, Public Comments, FEDERAL TRADE COMMISSION, at <http://www.ftc.gov/os/comments/franrulestaffrpt/index.htm> (last visited Mar. 4, 2005) [hereinafter *Public Comments*].

35. Registration of Foreign Offerings by Domestic Issuers, Exchange Act Release No. 33-4708 (July 9, 1964) [hereinafter Registration of Foreign Offerings].

36. See generally STAFF REPORT, *supra* note 3.

37. 16 C.F.R. § 436.1.

38. *Id.*

39. See *id.*

represented either orally or in writing to be a franchise.”<sup>40</sup> The Federal Trade Commission Act (the Act) defines “commerce” as “commerce among the several States or *with foreign nations*.”<sup>41</sup>

The Franchise Rule was promulgated by the FTC in 1979 to require franchisors to provide prospective franchisees with a detailed disclosure document and other contracts.<sup>42</sup> The Franchise Rule is the only federal regulation that deals exclusively with franchising, but it does not change the substantive relationship between the franchisor and franchisee.<sup>43</sup> The pre-sale disclosure is made through an offering circular, which contains “information about the franchisor, the franchised business, and the franchise agreement.”<sup>44</sup> The franchisor chooses either to use the disclosure as described in the Franchise Rule or the prescribed Uniform Franchise Offering Circular (UFOC), prepared by the North American Securities Administrators Association.<sup>45</sup>

### *B. Background to Rule Changes*

The Franchise Rule has been undergoing review since it was enacted.<sup>46</sup> Formal review of the Franchise Rule began in 1995.<sup>47</sup> The FTC issued a request for public comments in 1995 for the general purpose of gathering information regarding “the overall costs and benefits of the [Franchise] Rule and its overall regulatory and economic impact as a part of its systematic review of all current Commission regulations and guides.”<sup>48</sup> In 1997, there was an Advance Notice of Proposed Rulemaking (ANPR) issued, seeking comments on how to amend the Franchise Rule according to the information gained from the comments and conferences in response to the 1995 investigation.<sup>49</sup> In 1999, the FTC once

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40. *Id.*

41. Federal Trade Commission Act, 15 U.S.C. § 44 (1994) (emphasis added).

42. Philip F. Zeidman, *Franchising and Other Methods of Distribution: Regulatory Pattern and Judicial Trends*, in 43RD ANNUAL ADVANCE ANTITRUST SEMINAR DISTRIBUTION & MARKETING 2003 at 537 (PLI Corporate Law and Practice Course Handbook Series No. BO-0272, 2004).

43. *Id.*

44. *Id.* at 552.

45. *Id.*

46. *See generally* STAFF REPORT, *supra* note 3, at 1.

47. *See id.* at 2.

48. 1995 NPR, *supra* note 8. In this first review, the request was silent as to international issues; however, the commission received seventy-five comments in response to this and held two public conferences, one of which discussed inconsistencies between state and federal laws as well as recent developments in business opportunity sales. The second conference discussed specific changes to be made regarding developments in international franchising. *Id.*; *see also* STAFF REPORT, *supra* note 3, at 2.

49. Advance Notice of Proposed Rulemaking, Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 62 Fed. Reg. 9115 (proposed Feb. 28, 1997) (to be codified at 16 C.F.R. pt. 436).

again sent out a notice of proposed rulemaking in which it sought comments to discuss what was found as a result of the 1997 ANPR.<sup>50</sup> In response to the notice of proposed regulations, the staff of the FTC recommended retaining the Franchise Rule but agreed with the numerous comments that some changes needed to be made, including clarifying the extraterritorial scope of the Franchise Rule.<sup>51</sup>

The staff report recommends that the FTC not apply the Franchise Rule internationally.<sup>52</sup> The report noted that:

(1) the Commission did not contemplate international franchising when it promulgated the [Franchise] Rule; (2) the [Franchise] Rule's disclosures are aimed at the domestic market; (3) foreign franchise purchasers are sophisticated and do not need the [Franchise] Rule's protections; (4) attempting to comply with the Franchise Rule in foreign markets might result in franchisors disseminating inaccurate or misleading information; and (5) application of the Franchise Rule to international sales would unnecessarily impede competition.<sup>53</sup>

The FTC solicited and collected comments on the staff report until November 12, 2004, at which time the FTC began consideration of the comments made, and will eventually issue a revised Franchise Rule.<sup>54</sup>

### C. Proposed Revised Rule

The staff report published in August 2004 addresses the extraterritorial questions that were left unanswered.<sup>55</sup> Following is the language in the proposed rule that attempts to clarify the extraterritorial scope:

[i]n connection with the offer or sale of a franchise to be located *in the United States of America, its territories, or possessions*, unless the transaction is exempted under Subpart E of this Rule, it is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act.<sup>56</sup>

Looking at the plain language of the proposed revised rule, it seems as though many of the problems have been resolved; however, after closer examination, the language does not clarify whether the proposed revised rule will apply to all

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50. Notice of Proposed Rulemaking, Franchise Rule, 64 Fed. Reg. 57294 (proposed Oct. 22, 1999) (to be codified at 16 C.F.R. pt. 436).

51. STAFF REPORT, *supra* note 3, at 2-4.

52. *Id.* at 72.

53. *Id.*

54. Notice Announcing Publication of Staff Report on the Franchise Rule, Trade Regulation on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 69 Fed. Reg. 53,661 (Sept. 2, 2004) (to be codified at 16 C.F.R. pt. 436).

55. See generally STAFF REPORT, *supra* note 3, at Attach. B, p.7.

56. *Id.* at 304 (emphasis added).



types of international transactions.<sup>57</sup> The proposed revised rule covers the "sale of a franchise to be located in the United States of America, its territories, or possessions."<sup>58</sup> This would cover certain transactions that take place in the United States, but the question still remains as to whether the Franchise Rule will apply to transactions that take place in part beyond U.S. borders.<sup>59</sup>

### III. THE REVISED RULE CLARIFIES THE FTC POLICY REGARDING EXTRATERRITORIAL APPLICATION FOR PURE OUTBOUND AND PURE INBOUND TRANSACTIONS ONLY

In order to clarify the plain meaning of the Franchise Rule so that it only applies domestically, the FTC must make it clear exactly which transactions will or will not be included in the context of international franchising.<sup>60</sup> Three different types of international transactions need to be considered when clarifying the scope of the Franchise Rule: pure outbound transactions, pure inbound transactions, and mixed outbound/inbound transactions.<sup>61</sup>

#### A. *Pure Outbound Transactions*

In a pure outbound transaction, a U.S. franchisor sells a franchise located outside of the United States to a franchisee who lives outside of the U.S.<sup>62</sup> Considering the application of the Franchise Rule to pure outbound transactions involves analyzing two issues.<sup>63</sup> First, one must show congressional intent that the Franchise Rule applies to purely outbound transactions since "there is a presumption against extraterritorial application of any statute and against agency action taken under that statute."<sup>64</sup> Second, the "effect on domestic competition or domestic consumers" must be analyzed.<sup>65</sup> The current wording of the Franchise Rule does not meet either of these two requirements; therefore, the Franchise Rule does not currently apply to pure outbound transactions.<sup>66</sup>

There are many instances where Congress' intent negates the applicability of the Franchise Rule to pure outbound transactions.<sup>67</sup> Although the Act defines

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57. See Baer, *supra* note 12, at 60.

58. STAFF REPORT, *supra* note 3, at Attach. B, p.7.

59. See Baer, *supra* note 12, at 63.

60. *Id.* at 64.

61. *Id.* at 61.

62. *Id.*

63. *Id.*

64. *Id.*

65. Baer, *supra* note 12, at 61.

66. *Id.*

67. See generally 16 C.F.R. § 436.

commerce as "commerce among the several States or with foreign nations,"<sup>68</sup> the disclosure rules set forth in the Franchise Rule refer only to domestic situations.<sup>69</sup> One example is found in item (16)(iii)(c) of the Rule, which requires the disclosure of "all franchisees of the franchisor *in the State* in which the prospective franchisee lives or where the proposed franchise is to be located."<sup>70</sup> The use of the phrase "in the state" implies that Congress only considered domestic transactions when promulgating the Franchise Rule.<sup>71</sup> Another example is found in the Statement of Basis and Purpose, which explains that the purpose of the Franchise Rule is to protect against unfair and deceptive business practices in the *United States*.<sup>72</sup> Again, this implies that Congress only contemplated domestic transactions.<sup>73</sup> Furthermore, there were other chances in which Congress could have included reference to pure outbound transactions, but did not.<sup>74</sup> One instance where Congress was silent as to pure outbound transactions is found in the FTC Interpretive Guides and Summary of the Franchise Rule.<sup>75</sup> The discussion includes, "the effect of the FTC Rule on state franchise laws, but do[es] not mention foreign laws."<sup>76</sup> Finally, the FTC notes that it is the setting under which franchises are sold that puts a franchisee at a disadvantage when compared to the franchisor; therefore, there is the need for this Franchise Rule.<sup>77</sup> This suggests that the FTC only took into account domestic franchises because a sophisticated foreign investor is not one who needs protection.<sup>78</sup> Furthermore, the fact that international franchises vastly differ from domestic franchises suggests that the FTC did not account for both under the Franchise Rule.<sup>79</sup> Current regulations do not address the different agreements between the franchisor and franchisee abroad.<sup>80</sup>

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68. See 15 U.S.C. § 44.

69. Baer, *supra* note 12, at 61.

70. 16 C.F.R. 436 (16)(iii)(c) (emphasis added); see also Baer, *supra* note 12, at 61 (providing further discussion regarding pure outbound sales).

71. Baer, *supra* note 12, at 61.

72. *Id.*; see also Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, Statement of Basis and Purpose, 43 Fed. Reg. 59,614 (Dec. 21, 1978) (to be codified at 16 C.F.R. pt. 436).

73. Baer, *supra* note 12, at 61.

74. *Id.*

75. *Id.* (noting that the FTC rule has not been applied to a pure outbound transaction); see also Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures; Promulgation of Final Interpretive Guides, 44 Fed. Reg. 49,966 (proposed Aug. 24, 1979) (to be codified at 16 C.F.R. pt. 436).

76. Baer, *supra* note 12, at 61.

77. *Id.* (discussing the FTC promulgation of the Franchise Rule).

78. See Comment 22, *supra* note 19.

79. Baer, *supra* note 12, at 61.

80. See *id.*

The phrase "in the United States of America, its territories, or possessions," added to the proposed revised Franchise Rule, should eliminate all confusion as to the extraterritorial scope of the Franchise Rule when a franchisor is entering into a pure outbound transaction.<sup>81</sup> The phrase suggests that at least some of the transaction has to take place in the United States.<sup>82</sup> In a pure outbound transaction, all of the transaction takes place outside of U.S. borders or its territories, or possessions; theoretically, the proposed revised Franchise Rule will not be applicable to pure outbound transactions.<sup>83</sup>

### *B. Inbound Transactions*

The current and proposed revised Franchise Rule clearly applies to pure inbound transactions.<sup>84</sup> A pure inbound transaction is one in which a foreign franchisor sells a franchise that is to be located within the United States to a foreign franchisee.<sup>85</sup> In this transaction, it is clear that the Franchise Rule should and does apply since "it is difficult to find any persuasive reason why a foreign franchisor should not be required to comply with U.S. law where it has purposefully availed itself of the benefits of conducting business in the U.S."<sup>86</sup>

If the Rule did not apply to this type of transaction, it would place the U.S. franchisor at a distinct disadvantage in terms of other foreign franchisors, who do not have to abide by the same disclosure requirements.<sup>87</sup> Foreign franchisors will not have to comply with the same restraints as U.S. franchisors, such as waiting ten business days from disclosure to purchase or having to endure the expense of making an individualized disclosure document for every country in which the U.S. franchisor wants to do business.<sup>88</sup> The IFA argues that "absent a compelling U.S. public interest or an indication of systematic injury to foreign nationals by U.S. franchisors, there is no reason to create such an imbalance in international franchising."<sup>89</sup> Pure inbound transactions, however, can clearly be included within the language of the revised proposed rule because the whole transaction takes place within the United States.<sup>90</sup>

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81. See STAFF REPORT, *supra* note 3, Attach. B, p.7.

82. *Id.*

83. Baer, *supra* note 12, at 63.

84. *Id.* at 65.

85. *Id.*

86. *Id.*

87. *Id.*; see also IFA's Brief at 21, *Nieman* (no. 97-4745).

88. IFA's Brief at 21, *Nieman* (no. 97-4745).

89. *Id.*

90. See Baer, *supra* note 12, at 65.

### C. *Mixed Outbound and Mixed Inbound Transactions*

A mixed outbound transaction involves a franchisee residing in the U.S. buying a franchise from a U.S. franchisor, where the franchise is to be located outside of the U.S.<sup>91</sup> The argument for the application of the current Franchise Rule to mixed outbound transactions is stronger, considering that there is a “greater ‘nexus’ with the U.S.” than there is in a pure outbound transaction.<sup>92</sup> The typical U.S. franchisee is clearly someone who falls within a class protected by the Franchise Rule because the purpose behind the Rule is to protect U.S. citizens.<sup>93</sup> Furthermore, the assumption that the transaction was mostly negotiated and sold in the United States creates a link to commerce in the United States that is absent in a pure outbound transaction.<sup>94</sup>

Some franchisees express support for the application of the Franchise Rule to a mixed outbound transaction.<sup>95</sup> The concern is that the increase in franchise sales in foreign countries will have an impact on a domestic family of franchisees due to the fact that U.S. franchisors will turn to foreign franchisees before U.S. franchisees, since they won’t have to provide an FTC approved disclosure document.<sup>96</sup> Potential loopholes in the proposed revised Franchise Rule might alleviate this concern.<sup>97</sup> It is suggested that franchisors might form foreign independent entities for the purpose of evading FTC regulations.<sup>98</sup>

Some franchisees are also concerned that if the Franchise Rule does not apply to mixed outbound transactions, they will lose one form of recourse available to them if their franchise fails.<sup>99</sup> If no disclosure is required, a franchisee could buy a foreign franchise based on inaccurate and incomplete information, especially if there is no track record in the U.S. market.<sup>100</sup> These franchises might fail overseas because they have not been adapted to the special conditions found in the host country or because they are undercapitalized.<sup>101</sup> If

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91. *Id.* at 63.

92. *Id.*

93. *Id.*

94. *Id.*

95. See Harold Brown, *Comment 4, #17 Public Workshops: Franchise Rulemaking (07/97)*, FEDERAL TRADE COMMISSION, Mar. 10, 1997, at <http://www.ftc.gov/bcp/franchise/comments/4brown.htm> (last visited Mar. 4, 2005).

96. *Id.*

97. *Id.*

98. *Id.*

99. See S. Beavis Stubbings, *Comment 21, #17 Public Workshops: Franchise Rulemaking (07/97)*, FEDERAL TRADE COMMISSION, Apr. 29, 1997, at <http://www.ftc.gov/bcp/franchise/comments/csusak21.htm> (last visited Mar. 4, 2005).

100. *Id.*

101. *Id.*

the franchisor is not required to disclose the same information as the FTC requires, the investment is a risky endeavor for the franchisee overseas.<sup>102</sup>

Although it seems as though the Franchise Rule would apply in this situation, problems arise. For example, a country in which the franchise is to be located also has a franchise disclosure law with which the franchisor has to comply.<sup>103</sup> In determining whether the Franchise Rule applies, the court might be forced to look at which disclosure requirements are more applicable to the franchisee, which leads to yet another problem.<sup>104</sup> If the U.S. franchisor delivers a standard franchise offering circular to the U.S. franchisee in a foreign country, "it is likely that significant parts of the offering circular will be irrelevant."<sup>105</sup> For example, there might be information concerning initial investment, claims on earnings, and factors in local markets that will be irrelevant to that franchisee.<sup>106</sup> The franchisor will then have to create a specific disclosure for each country.<sup>107</sup> This would lead to the problems expressed by some franchisors concerning an undue financial burden to create franchise offering circulars for individual countries so that the franchisee can work from information that is relevant for them.<sup>108</sup>

This is already a problem that is faced by franchisors in the U.S.<sup>109</sup> In comments made by the IFA, franchisors and franchisees concerns were expressed regarding the extraterritorial application of the Franchise Rule.<sup>110</sup> The IFA argues that the factual disclosures required by the Franchise Rule are not accurate or relevant in foreign countries.<sup>111</sup> Differences arise in financial disclosures, such as costs involved to the franchisee.<sup>112</sup> The franchisor would therefore have to draft a separate disclosure statement for each country, which could be very costly.<sup>113</sup> To get some idea of how much burden disclosure can put onto a franchisor, Marriott "uses different disclosure documents for each brand that it franchises, and each disclosure document ranges between one and one-half and two inches in thickness, double-sided copy."<sup>114</sup> This could also be

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102. *Id.*

103. *See* Baer, *supra* note 12, at 63.

104. *Id.*

105. *Id.* at 63-64.

106. *Id.* at 64.

107. *Id.*

108. *See Comment 22, supra* note 19.

109. *See id.*

110. *See id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. Steven Goldman & Mark Forseth, Marriott International, Inc., *Comment 35, #3 16 CFR Part 436*, FEDERAL TRADE COMMISSION, Dec. 22, 1999, at

very difficult considering there is no model for drafting these documents, since state and federal regulations do not take into account potential international franchising issues.<sup>115</sup> Requiring franchisors to do this type of drafting is impractical and may also result in misleading disclosures to international franchisees because the information may be inapplicable and could lead to the franchisee making decisions based on inaccurate information.<sup>116</sup>

The question also arises as to whether the Rule would apply in a situation that involves a U.S. franchisee joining foreign investors to form a foreign corporation.<sup>117</sup> This tactic is used by some U.S. franchisees who want to own a franchise in a foreign country despite the fact that they do not know the local culture well enough to compete successfully in that market.<sup>118</sup> Although U.S. case law suggests that a corporation would be seen as a foreign entity for the purposes of jurisdiction, the courts has never ruled on whether the corporation would get the protection of the Rule.<sup>119</sup>

The IFA again points out that application of the Franchise Rule in this type of situation would simply not fit.<sup>120</sup> The relationship between international franchisors and franchisees is structured much differently from the relationship between domestic franchisors and franchisees.<sup>121</sup> Unlike the two-tiered relationship in the United States, there are a number of different structures found internationally, such as that of the master franchise, which involves a “domestic franchisor, a master franchisee in the foreign country . . . and the operators of individual franchised units within the foreign country.”<sup>122</sup> The relationship between a franchisor in the United States, who grants developer rights for an entire country to a person who agrees to develop a certain number of franchises in that country, is another example of an international franchise structure that differs from those found in the United States<sup>123</sup> Finally, the structure could

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<http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment035.htm> (last visited Mar. 4, 2005). Marriott has seven hotel brands in the U.S., along with five hotel brands across the globe.

115. See IFA’s Brief at 9, *Nieman* (no. 97-4745).

116. *Id.*

117. See Baer, *supra* note 12, at 64.

118. See IFA’s Brief at 9, *Nieman* (no. 97-4745).

119. Baer, *supra* note 12, at 64; see, e.g., *Koehler Enters., Inc. v. Shell Oil Co.*, Bus. Franchise Guide (CCH) 10,252 (D.C. Md. 1993); *Hengel, Inc. v. Hot ‘n Now, Inc.*, 825 F. Supp. 1311 (N.D. Ill. 1993); *Taha v. Engstrand*, 987 F.2d 505 (8th Cir. 1993); *Smith Setzer v. S.C. Procurement Review Panel*, 20 F.3d 1311 (4th Cir. 1994).

120. See IFA’s Brief at 7, *Nieman* (no. 97-4745).

121. See *id.* at 9.

122. *Id.* at 8.

123. *Id.*

involve a franchisor in the United States who enters into an arrangement with an equity joint venture in a foreign country.<sup>124</sup>

Despite the fact that it seems mixed, outbound transactions would automatically be included in the current Franchise Rule; the current wording is not clear on this issue, and the proposed revised Franchise Rule does not clarify this area.<sup>125</sup> The additional phrase "in the United States of America, its territories, or possessions" does not clarify whether the entire transaction needs to take place in the U.S., or if the disclosure requirements will still apply when only a portion of the transaction takes place in the U.S.<sup>126</sup> Franchisors will still be unsure whether they are required to provide disclosures in a transaction that involves some kind of foreign element.<sup>127</sup>

A mixed inbound transaction is a business relationship that encompasses many different variations on the inbound transaction.<sup>128</sup> For example, it could include a situation in which the franchisee is a foreign national living in the U.S. or a U.S. citizen living in a foreign country.<sup>129</sup> It could also include a situation in which all parties are foreign nationals and the franchise will be located within the United States.<sup>130</sup> The Franchise Rule is unclear on how to deal with situations that involve foreign elements such as this.<sup>131</sup> Because the courts have never addressed these particular issues, there is much speculation as to how each of these transactions should be handled; however, no concrete guidance exists.<sup>132</sup>

The additional phrase "in the United States of America, its territories, or possessions" suggests that the FTC is taking a territorial approach when limiting the scope of the Franchise Rule.<sup>133</sup> This would eliminate its application to mixed inbound transactions because the nationality or citizenship of the individuals involved in the transaction would be irrelevant.<sup>134</sup> The revised proposed Franchise Rule needs to further clarify that the FTC is taking a territorial approach, meaning that the rule will only concentrate on the

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124. *Id.*

125. Baer, *supra* note 12, at 63; *see generally* STAFF REPORT, *supra* note 3.

126. *See* STAFF REPORT, *supra* note 3, at Attach. B, p.7.

127. *See generally id.*

128. Baer, *supra* note 12, at 66.

129. *Id.*

130. *Id.*

131. *Id.*

132. *See id.*

133. *See* STAFF REPORT, *supra* note 3, Attach. B, p.7.

134. *See* L. Seth Stadfeld, *Comment 23, #3 16 CFR Part 436*, FEDERAL TRADE COMMISSION, Dec. 21, 1999, at <http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment023.htm> (last visited Mar. 5, 2005).

geographical location of the transaction, when determining the applicability of the disclosure requirements.<sup>135</sup>

#### IV. THE REVISED FRANCHISE RULE FAILS TO CLARIFY THE EXTRATERRITORIAL TESTS DEVELOPED BY U.S. DISTRICT COURTS

The scope of the Franchise Rule remains unclear. In *Nieman v. Dryclean U.S.A. Franchise Co., Inc.*,<sup>136</sup> the Supreme Court developed the presumption against an extraterritorial application test in *Equal Employment Opportunity Commission v. Arabian American Oil Co.*<sup>137</sup> Under this test, Congress acts under the presumption that the legislation does not apply extraterritorially, absent a clear statement of intent to the contrary.<sup>138</sup> However, the district courts have not applied this test in a consistent manner.<sup>139</sup> *Branch v. FTC* applied a “conduct and effects” test when interpreting the definition of commerce as defined by the FTC.<sup>140</sup> *Nieman*, however, applied the straight “presumption against extraterritoriality” test when applying the same case.<sup>141</sup> The FTC needs to provide further guidance in order to clear up the confusion among the district courts.<sup>142</sup> The phrase “in the United States of America, its territories, or possessions” does not provide sufficient clarification for the courts when determining which of the two tests to apply.<sup>143</sup> Although the phrase may be the clear statement of intent that the court is looking for in applying the presumption against extraterritoriality test, it does not clarify whether the disclosure requirements will apply if the affects of the transaction will be felt in the U.S.<sup>144</sup>

##### A. *Branch v. FTC*

In *Branch v. FTC*, the 7th Circuit Court of Appeals found that the FTC’s unfair trade provisions applied to the extraterritorial conduct of a U.S. citizen.<sup>145</sup> Branch was a U.S. citizen who operated correspondence study courses with individuals from Latin America.<sup>146</sup> He represented that the institute had the

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135. *Id.*

136. See generally *Nieman v. Dryclean U.S.A. Franchise Co.*, 178 F.3d 1126 (11th Cir. 1999).

137. See *id.* at 1129; see also *Equal Employment Opportunity Commission v. Arabian American Oil Co.*, 499 U.S. 244, 248 (1991).

138. See *Nieman*, 178 F.3d 1126.

139. See *id.*; see also *Branch v. Fed. Trade Comm’n*, 141 F.2d 31, 35 (7th Cir. 1944).

140. See *Branch*, 141 F.2d 31.

141. *Nieman*, 178 F.3d at 1129.

142. Costello, *supra* note 7.

143. See *id.*; see also STAFF REPORT, *supra* note 3, at Attach. B, p.7.

144. See Costello, *supra* note 7.

145. *Branch*, 131 F.2d at 36.

146. *Id.* at 33.



ability to grant certified diplomas in these areas and that it was an “officially recognized University in accordance with the laws of [sic] United States.”<sup>147</sup> The school, however, was not an institute or a university.<sup>148</sup> Branch’s only qualifications were his college diploma and his admission to practice law.<sup>149</sup>

The court in this case looked at whether the FTC could properly enforce an unfair trade violation against Branch.<sup>150</sup> The activities Branch was engaged in fit within the definition of “commerce” as defined in the Act, and therefore found it was properly within the authority of the FTC.<sup>151</sup> Furthermore, the court found that there was a public interest involved in protecting the competitive interests of other U.S. correspondence schools.<sup>152</sup> They found the FTC still had jurisdiction because “it was conceived, initiated, concocted, and launched on its way in the United States. That the persons deceived were all in Latin America is of no consequence. It is the location of the petitioner’s competitors which counts.”<sup>153</sup>

The court relied on the precedent set by *Blackmer v. United States* and *Cook v. Tait*.<sup>154</sup> The precedent suggested that it is within “[t]he right of the United States to control the conduct of its citizens in foreign countries in respect to matters which a sovereign ordinarily governs within its own territorial jurisdiction.”<sup>155</sup> As applied in the *Branch* case, if the acts of Branch were committed to the disadvantage of other competing U.S. citizens, the United States has a right to protect that competing interest even if the customer could not look to the United States for protection.<sup>156</sup> Although this case does not apply the Franchise Rule, the court does interpret “commerce” as defined in the Act to apply extraterritorially when U.S. competitive interests are at stake.<sup>157</sup> *Branch* is an example of how the court can apply a statute extraterritorially without clear intent from Congress based on the fact that the conduct, although done mostly outside the borders of the United States, still has an effect on U.S. commerce.<sup>158</sup>

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147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.* at 34.

151. *Branch*, 141 F.2d at 34.

152. *Id.*

153. *Id.* at 34-35.

154. *Id.* at 35 (discussing *Blackmer*, 284 U.S. 421 (1932); *Cook*, 265 U.S. 47 (1924)).

155. *Id.* (citing *Blackmer*, 284 U.S. at 436-38; *Cook*, 265 U.S. at 54-56).

156. *Id.*

157. *Branch*, 141 F.2d at 35.

158. *Id.*

*B. Nieman v. Dryclean U.S.A. Franchise Co.*

In *Nieman*, the Court of Appeals for the 11th Circuit found that the FTC disclosure requirements of the Franchise Rule do not apply to franchisees who are not U.S. citizens.<sup>159</sup> The *Branch* court came to the opposite result even though the deceived students were also foreign citizens.<sup>160</sup> Since “commerce” is defined the same way for the Franchise Rule, the court could have applied the same conduct-effects test to find that the disclosure requirements were necessary in this case.<sup>161</sup> The court instead used the presumption against extraterritorial application test to find that the disclosure requirements did not apply to that transaction.<sup>162</sup>

*Nieman*, a citizen of Argentina, along with four other businessmen, all of whom were domiciled in Argentina,<sup>163</sup> entered into a master franchise agreement with the Dryclean U.S.A. Franchise Co. (DUSA) in order to receive the exclusive right to sell DUSA franchises throughout Argentina.<sup>164</sup> In accordance with this agreement, *Nieman* gave DUSA a \$50,000 nonrefundable deposit to keep DUSA from negotiating with anyone else regarding that territory for sixty days.<sup>165</sup> *Nieman* tried to obtain the necessary financing but was unable to do so and DUSA refused to return the \$50,000 deposit.<sup>166</sup> *Nieman* sued for the return of this deposit based on his allegation that DUSA failed to make the disclosures required under the Florida Deceptive and Unfair Trade Practices Act (DUTPA) and under the Franchise Rule.<sup>167</sup> In defense of these allegations, DUSA claimed that since the agreement took place in Argentina, neither of the disclosure requirements had extraterritorial application and therefore, did not apply in this case.<sup>168</sup> The district court granted summary judgment in favor of *Nieman* and granted him a full refund of the \$50,000 deposit, based on its interpretation of the DUTPA.<sup>169</sup> The district court found that the DUTPA did apply to transactions such as this one based on Congress’ power “to prevent unfair trade practices in foreign commerce by citizens of the United States, although some acts are done outside the territorial limits of the United States.”<sup>170</sup> The appeals court reversed, based on the finding that Congress did not intend for the

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159. *Nieman*, 178 F.3d 1126 at 1130-31.

160. *Branch*, 141 F.2d at 35.

161. *Nieman*, 178 F.3d at 1129.

162. *Id.*

163. Appellant’s Brief at 6, *Nieman*, (No. 97-4745).

164. *Id.* at 1128.

165. *Nieman*, 178 F.3d 1126 at 1128.

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

Franchise Rule to apply to extraterritorial agreements.<sup>171</sup> The DUTPA contains requirements found in the Franchise Rule, which were “promulgated pursuant to the Federal Trade Commission Act.”<sup>172</sup> Nieman was able to sue under the DUTPA because the Florida statute creates a private cause of action for a U.S. franchisee, whereas the Franchise Rule creates no private cause of action.<sup>173</sup> Because Nieman is a citizen of Argentina, the only way for a foreign franchisee to sue in regards to a foreign franchise deal is if the Franchise Rule has an extraterritorial application.<sup>174</sup> The court must find congressional intent of extraterritoriality to be able to construe the Franchise Rule to have extraterritorial application.<sup>175</sup>

The court further stated that when interpreting acts of Congress, the presumption is that the legislation only applies to the United States, unless there is intent found to the contrary.<sup>176</sup> There are two main reasons for this presumption.<sup>177</sup> First, the assumption is “that Congress is primarily concerned with domestic conditions.”<sup>178</sup> Second, this presumption “serves to protect against unintended clashes between [U.S.] . . . laws and those of other nations which could result in international discord.”<sup>179</sup> Although the FTC Franchise Rule refers to “foreign commerce,” the phrase is not enough to indicate congressional intent that the act applies extraterritoriality.<sup>180</sup> Congress is aware “of the need to make a clear statement of [the] extraterritorial effect”<sup>181</sup> as proven by the many statutes in which Congress has explicitly made such statements.<sup>182</sup>

The court found that Congress did not make this type of clear statement to indicate that the Franchise Rule would apply extraterritorially.<sup>183</sup> *Equal Employment Opportunity Commission v. Arabian American Oil Co.* addressed this same issue when interpreting the scope of Title VII of the Civil Rights Act of 1964.<sup>184</sup> In reaching the conclusion that this statute did not apply

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171. *Nieman*, 178 F.3d at 1131.

172. *Id.* at 1129 (discussing 15 U.S.C. § 41); *see also* 16 C.F.R. § 436 (1998).

173. *Nieman*, 178 F.3d at 1129; *see also* FLA. STAT. ANN. § 501.211 (West 1994).

174. *Nieman*, 178 F.3d at 1129.

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.* (quoting *Foley Bros., Inc. v. Filardo*, 336 U.S. 281, 285 (1949)).

179. *Id.* (quoting *McCulloch v. Sociedad Nacional de Maneros de Honduras*, 372 U.S. 10, 20-22 (1963)).

180. *Nieman*, 178 F.3d at 1129 (citing *Equal Employment Opportunity Comm'n*, 499 U.S. at 251).

181. *Id.*

182. *Id.* (citing *The Biological Weapons Anti-Terrorism Act of 1989*, 18 U.S.C. § 175(a) (1994)).

183. *Id.* at 1130.

184. *Equal Employment Opportunity Comm'n*, 499 U.S. at 248.

extraterritorially, the court looked to the congressional intent behind the word “commerce.”<sup>185</sup> The Civil Rights Act defined “commerce” in a slightly different way than the Franchise Rule.<sup>186</sup> Title VII defines “commerce” as activity “between a State and any place outside thereof.”<sup>187</sup> The court found this language to be ambiguous and “that it represented mere boilerplate language.”<sup>188</sup> Looking to the statute as a whole, the court found that the statute had a purely domestic focus due to provisions that only referred to state activity.<sup>189</sup> Furthermore, the statute was silent as to foreign nations and proceedings.<sup>190</sup> Similarly, even though the Franchise Rule defines commerce as “commerce among the several States or with foreign nations,”<sup>191</sup> the court found this language to be too ambiguous and not a clear indication of Congress’ intent to include an extraterritoriality scope.<sup>192</sup>

Even if this wording suggests that Congress did intend for the franchise regulations to apply extraterritorially, the court found no evidence that Congress intended for the Franchise Rule to apply to a franchisor in the United States dealing with a foreign franchisee in regards to a franchise located in a foreign country.<sup>193</sup> First, the court looked at the legislative history of the Franchise Rule.<sup>194</sup> It found that when Congress wrote the Statement of Bias and Purpose, the history of U.S. franchising was discussed in detail; however, Congress was silent regarding the problems of franchising in foreign countries.<sup>195</sup> This silence indicates that Congress did not mean for the Act to extend to franchises in foreign countries.<sup>196</sup>

The court also looked to the other provisions of the Act and found that “the [Franchise] Rule itself reveal[s] a purely domestic focus.”<sup>197</sup> For example, the Act only mentions potential conflicts with state law, but there is no mention of conflicts with foreign law.<sup>198</sup> The Act also directs franchisees to consult with certain agencies found within the United States, but does not mention agencies in

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185. *Id.* at 249.

186. *Id.* at 250.

187. *Id.* at 249.

188. Appellant’s Brief at 17, *Nieman* (no. 97-4745).

189. *Equal Employment Opportunity Comm’n*, 499 U.S. at 255.

190. Appellant’s Brief at 18, *Nieman* (no. 97-4745).

191. 15 U.S.C. § 44.

192. *Nieman*, 178 F.3d at 1130.

193. *Id.*

194. *See id.* at 1131.

195. *Id.*

196. *Id.*

197. *Id.*

198. *Nieman*, 178 F.3d at 1131; *see also* 15 U.S.C. § 44.

foreign countries.<sup>199</sup> Furthermore, the Franchise Rule is silent as to whether the Act would apply to foreign franchisees.<sup>200</sup> Again, the provisions in the Final Interpretive Guides indicated conflicts with state and local laws, but mentioned failed to mention foreign laws.<sup>201</sup>

The final piece of evidence is found in a recent Advance Notice of Proposed Rulemaking, where the FTC proposed to modify the Franchise Rule by clarifying that the rule "does not apply to the sale of franchises to be located outside the United States."<sup>202</sup> Although this change has not yet been implemented, this indicates the intent of Congress to limit the scope of the Franchise Rule to domestic franchisees only.<sup>203</sup> Since *Nieman* did not make it to the Supreme Court, this decision "is not binding in the other federal circuits."<sup>204</sup> Until the proposed amendments to the Franchise Rule are adopted, there is no certainty regarding whether franchisors will have to comply with FTC disclosure regulations unless they find themselves in the same situation as in *Nieman*, because the Court does not suggest that the case applies to all outbound transactions.<sup>205</sup> The proposed revised rule might provide the guidance the court is looking for, but there needs to be more clarification to develop a purely territorial approach.<sup>206</sup>

#### V. THE PROPOSED REVISED FRANCHISE RULE IS NOT SUFFICIENT

Simply adding the phrase "in the United States of America, its territories, or possessions" will not be sufficient to clear up the confusion as to the extraterritorial application of the Franchise Rule.<sup>207</sup> This phrase only clarifies that it does not cover pure outbound transactions and pure inbound transactions. However, there will still be confusion as to whether the Franchise Rule is applicable to mixed outbound and certain mixed inbound transactions.<sup>208</sup> The phrase suggests that the FTC assesses the geographical location of the transaction, as opposed to the citizenship or residence of the individuals involved in the transaction, through a territorial approach to define the scope of the Franchise Rule.<sup>209</sup> The FTC simply needs to take this limitation one step further

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199. *Nieman*, 178 F.3d at 1131.

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.*

204. INTERNATIONAL FRANCHISING, *supra* note 2, at 171.

205. *Id.* at 172.

206. See STAFF REPORT, *supra* note 3, at 72.

207. See *id.* at Attach. B, p.7.

208. See Baer, *supra* note 12, at 62-63.

209. See STAFF REPORT, *supra* note 3, at 72-75.

in defining which part, if any, of the transaction needs to take place within the United States for the disclosure requirements to be applicable.<sup>210</sup> The Securities and Exchange Commission (SEC) provides an example of the additional steps that might be required.<sup>211</sup>

*A. Analogous Situation with the Securities Act of 1933- Regulation S*

The Securities Act of 1933 (the 1933 Act) was passed by Congress in response to the stock market crash of 1929.<sup>212</sup> The 1933 Act “regulates the public offering and sale of securities by mandating public disclosures through the registration of securities.”<sup>213</sup> The purpose of this act is to protect investors by giving them access to information so they can make informed investment decisions.<sup>214</sup> The problem regarding the extraterritorial scope of the 1933 Act was that Congress used “interstate commerce” as the jurisdictional boundary for the application of the act.<sup>215</sup> However, Congress then defined “interstate commerce” as “trade or commerce in securities . . . among the several States or between the District of Columbia or any Territory of the United States and any State or other Territory, or *between any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia.*”<sup>216</sup> This definition opened up the possibility of Congress regulating activity in mixed outbound transactions.<sup>217</sup> If applying a literal meaning to this definition, there is the potential for a disclosure under § 5 of the 1933 Act to be triggered by mail or telephone calls in the United States made during the process of selling a security.<sup>218</sup> Similarly, in the event that foreign offerings were traded to U.S. investors in the U.S. market, the disclosure requirements would be triggered.<sup>219</sup>

In response to this dilemma, the SEC promulgated Regulation S “to redefine and formalize the SEC’s prior informal position regarding [the]

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210. See Carl C. Jeffers, Intel Marketing Systems, *Comment 116, #17 Public Workshop: Franchise Rulemaking (07/97)*, FEDERAL TRADE COMMISSION, at <http://www.ftc.gov/bcp/franchise/comments/116jeffe.htm> (last visited Mar. 6, 2005).

211. See generally Registration of Foreign Offerings, *supra* note 35.

212. Brandy L. Fulkerson, *Extraterritorial Jurisdiction and U.S. Securities Law: Seeking Limits for Application of the 10(B) and 10B-5 Antifraud Provisions*, 92 KY. L.J. 1051, 1053 (2004).

213. *Id.*

214. *Id.*

215. *Id.*

216. 15 U.S.C. § 77b(a)(7) (2000) (emphasis added).

217. See Fulkerson, *supra* note 212, at 1054.

218. Jaime M. Jackson, “Regulation S” and the Territorial Approach to Securities Regulation: Are they Effective?: A Study of United States Securities Regulation in Light of British and Chinese Securities Regulations, 28 BROOK. J. INT’L L. 613, 613-14 (2003); see also Marc I. Steinberg & Daryl L. Lansdale, Jr., *Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market*, 29 INT’L LAW. 43, 44-45 (1995).

219. Jackson, *supra* note 218, at 614.

extraterritorial application of the '33 Act's registration provisions."<sup>220</sup> This informal statement was made in 1964 by the SEC in response to a 1964 report that was issued by the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad.<sup>221</sup> In this release, the SEC noted:

that although the definition of interstate commerce in the Securities Act was broad enough to encompass virtually any offering of securities made by a domestic issuer to foreign investors, it would not take enforcement action for failure to register if a domestic issuer sold its securities abroad exclusively to foreign investors in a manner reasonably designed to prevent the distribution or redistribution of such securities into the United States or to U.S. persons.<sup>222</sup>

The SEC took this position because the primary purpose of the registration requirements is to protect American investors.<sup>223</sup> Unfortunately, the SEC created more uncertainty because, in this attempt to set standards applicable to extraterritorial offerings, the informal positions taken were inconsistent and vague.<sup>224</sup>

Regulation S was adopted in 1990 in order to clarify this position.<sup>225</sup> The new regulation creates two safe harbor exemptions from the disclosure requirements of § 5 of the Securities Act.<sup>226</sup> Regulation S distinguishes between the offer or sale of securities that occurs within the United States and the offer or sale of securities that occurs outside the United States.<sup>227</sup> In doing this, "the SEC's territorial approach to securities regulation recognizes the primacy of the laws in which the market and transaction are located rather than focusing on the nature of the securities or the nationality of purchasers, offerors, or issuers."<sup>228</sup> As stated before, the primary reason for the registration requirements is to protect U.S. investors and those purchasing securities in the U.S. markets.<sup>229</sup> In addition, investors participating in global markets have a reasonable expectation

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220. Fulkerson, *supra* note 212, at 1054.

221. Linda C. Quinn et al., *Internationalization of the Securities Market*, 712 *PLI/CORP* 7, 35 (1990) (discussing SEC Release No. 4708); *see also* Registration of Foreign Offerings, *supra* note 35.

222. *Id.*

223. *Id.*

224. Jackson, *supra* note 218, at 614.

225. *Id.*

226. *Id.*

227. *Id.*; *see also* Registration of Foreign Offerings, *supra* note 35, at 1.

228. Jackson, *supra* note 218, at 615.

229. Registration of Foreign Offerings, *supra* note 35, at 1.

that they are acting under the applicable foreign jurisdiction.<sup>230</sup> These two factors justify the application of the registration requirements under § 5 of the 1933 Act to situations involving transactions occurring within the United States as opposed to those occurring outside its borders.<sup>231</sup> The courts will determine on a case-by-case basis whether a transaction is considered to be “outside of the United States.”<sup>232</sup> The only guidance given in respect to this is that both the offer and the sale must be conducted outside the United States.<sup>233</sup> No other factors are given to aid in this determination.<sup>234</sup> It does clarify, however, that a U.S. person, for the purposes of the 1933 Act, means U.S. residency as opposed to U.S. citizenship.<sup>235</sup> Not only did Regulation S provide “certainty regarding exemption [from the registration requirements], Regulation S was promulgated to facilitate foreign securities offerings by U.S. issuers and to allow U.S. investors to provide financings in foreign capital markets. . . . [It] was also intended to increase U.S. competitiveness offshore.”<sup>236</sup>

Regulation S is consistent with the general approach that investors who go outside the U.S. to acquire securities forego the protections provided by the U.S. registration requirements.<sup>237</sup> “Regulation S states that ‘(a)s investors choose their markets, they choose the laws and regulations applicable in such markets.’”<sup>238</sup> It naturally follows that registration requirements are only needed if the transaction takes place in the U.S.<sup>239</sup>

One safe harbor exemption is found in Rule 903.<sup>240</sup> First, the offer and the sale “must be made in an ‘offshore transaction.’”<sup>241</sup> The sale must not have been made to a person in the United States, and the buyer must be outside the United States when the order or the transaction takes place on the floor of a foreign securities exchange.<sup>242</sup> Second, no directed selling efforts can be made in the United States by the issuer of the security, the underwriter of the security, or any other distributor of the security.<sup>243</sup> A directed selling effort is an activity

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230. *Id.*

231. *Id.*

232. *Id.*

233. *Id.* at 2.

234. *Id.*

235. Registration of Foreign Offerings, *supra* note 35, at 1.

236. Jackson, *supra* note 218, at 618-19.

237. *Id.* at 619.

238. *Id.* (quoting Offshore Offers and Sales, 55 Fed. Reg. 18,306, 18,308 (proposed May 2, 1990) (to be codified at 17 C.F.R. pts. 200 & 230)).

239. *Id.*

240. *Id.* at 620.

241. *Id.*

242. Jackson, *supra* note 218, at 620.

243. *Id.*



that "could reasonably be expected to condition the market in the United States for any of the securities offered or sold in reliance on Regulation S."<sup>244</sup> The second safe harbor exemption works the same way as Rule 903 but in regards to the resale of a security.<sup>245</sup>

Both of these safe harbor exemptions were amended in 1998 in order to prevent abusive practices by mostly domestic issuers who were taking advantages of loopholes in the exemptions.<sup>246</sup> The amendments prohibited certain illegal resales and no longer allowed promissory notes to be used in the purchase of Regulation S securities.<sup>247</sup> Furthermore, Rule 144 remedied the abusive practice of using the resale safe harbor exemption to "wash off" restrictions on the securities by imposing a one year waiting period before the resale of the securities.<sup>248</sup>

### *B. The FTC Will Need to Adopt a Statement Similar to Regulation S*

The FTC's concerns regarding the extraterritorial application of the Franchise Rule are similar to those of the SEC prior to the promulgation of Regulation S.<sup>249</sup> Both the Franchise Rule and the 1933 Act govern the registration requirements that need to be disclosed before a person makes an investment.<sup>250</sup> Similar reasons exist for both of these requirements.<sup>251</sup> First, the SEC and the FTC are acting for the purpose of protecting the American investor.<sup>252</sup> Second, choice of law issues between United States and foreign regulations have the potential to complicate business transactions.<sup>253</sup> Furthermore, other countries are better equipped to devise laws to protect those that invest in markets encompassed by their borders.<sup>254</sup>

Regulation S provides better guidance for the courts and those in the business of selling securities than the wording proposed by the FTC to change the extraterritorial scope of the Franchise Rule.<sup>255</sup> The 1933 Act defined commerce in a way that is almost identical to that in the FTC Act.<sup>256</sup> The FTC

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244. *Id.* at 620-21.

245. *Id.* at 623.

246. *Id.* at 625.

247. *Id.* at 630.

248. Jackson, *supra* note 218, at 630-31.

249. *See generally* STAFF REPORT, *supra* note 3.

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.*

254. *Id.*

255. *See generally* Offshore Offers and Sales, 55 Fed. Reg. 18,306, 18,308 (proposed May 2, 1990) (to be codified at 17 C.F.R. pts. 200 & 230).

256. *See generally* 15 U.S.C. § 44.

proposes that the words "in the United States of America, its territories, or possessions" be added in order to clarify that the Franchise Rule will only apply to domestic transactions.<sup>257</sup> This, however, only clarifies the act regarding pure outbound transactions and does not provide any guidance for mixed outbound and certain inbound transactions that may still exist beyond the scope of the Franchise Rule.<sup>258</sup> The FTC should take the additional step of providing exemptions, much like the safe harbor exemptions, that detail the mixed outbound and mixed inbound transactions that are not intended to be covered by the Franchise Rule.

## VI. CONCLUSION

Globalization demands clarification of the Franchise Rule regarding applicable disclosure requirements.<sup>259</sup> Adding the phrase "in the United States of America, its territories, or possessions" will only clarify that the Franchise Rule does not apply to a pure outbound transaction.<sup>260</sup> This does not indicate whether the franchisor will have to produce disclosure documents to a franchisee if the negotiations take place in the United States, the franchisee is located in the United States, or whether the phrase refers only to where the franchise will be located.<sup>261</sup>

In order to modify the Franchise Rule so that it is clear that the FTC does not wish to apply the rule extraterritorially, further action will need to be taken.<sup>262</sup> The comments that were submitted in response to the staff report outlined several suggestions to clarify the Franchise Rule.<sup>263</sup> One suggestion is that the limiting language be reflected in the Interpretive Guides which should "specifically state that a disclosure document must be used only for the offer and sale of franchises in the U.S. This statement should also indicate that this is a clarification and reiteration of the FTC's position that the disclosure requirements do not apply to international transactions."<sup>264</sup> It was also suggested that the clarification come in an Informal Advisory Opinion, which should read:

'The FTC Rule's intention is to protect U.S. franchisees. It is not the FTC Rule's intention to put U.S. franchisors at a competitive disadvantage in their

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257. See STAFF REPORT, *supra* note 3, at Attach. B, p.7.

258. See INTERNATIONAL FRANCHISING, *supra* note 2, at 170-72.

259. Baer, *supra* note 12, at 68.

260. *Id.* at 61-63.

261. See generally STAFF REPORT, *supra* note 3.

262. See Comment 116, *supra* note 210.

263. See generally Public Comments, *supra* note 34.

264. Comment 82, *supra* note 19.

international franchising efforts in so doing. Therefore, the FTC Rule does not apply to an offer or sale of a franchise to a foreign prospective franchisee for a franchise to be located entirely outside the U.S. In mixed transactions, such as the offer to a U.S. citizen of a franchise to be located outside the U.S., the Rule will govern only if the franchisor's franchising activities result in a substantial and continuing impact on U.S. commerce.<sup>265</sup>

The FTC should also take into consideration the clarification made by the SEC when it promulgated Regulation S.<sup>266</sup> The definition of "interstate commerce" in the 1933 Act is almost identical to the definition of commerce found in the Franchise Rule.<sup>267</sup> Furthermore, the goals behind changing the scope of the 1933 Act are similar to the goals behind changing the Franchise Rule.<sup>268</sup> Finally, the SEC had to take into account the same factors, such as the globalization of securities transactions, in determining whether to revise the 1933 Act.<sup>269</sup>

If the FTC does not clarify the Franchise Rule to a greater degree than proposed in the revised rule, confusion will still exist as to what transactions the Franchise Rule applies.<sup>270</sup> There are many variations of foreign elements that may be involved in mixed outbound and mixed inbound transactions.<sup>271</sup> Simply adding the phrase "in the United States of America, its territories, or possessions" does not indicate what part of the transaction needs to be in the United States.<sup>272</sup> Furthermore, the FTC needs to clarify whether they are taking a purely territorial approach when limiting the scope of the Franchise Rule or whether they follow the overriding principle of protecting the U.S. franchisee.<sup>273</sup> These two approaches conflict when considering a mixed outbound transaction.<sup>274</sup> Additional steps need to be taken, whether it is written in the rule itself, the interpretive guides, or the Statement of Basis and Purpose to make clear the intent of the FTC with regards to the extraterritorial scope of the Franchise Rule.

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265. Gary R. Duvall, Graham & Dunn, *Comment 19, #17 Public Workshops: Franchise Rulemaking (07/97)*, FEDERAL TRADE COMMISSION, Apr. 26, 1997, at <http://www.ftc.bcp/franchise/comments/duval19.htm> (last visited Mar. 6, 2005).

266. See Regulation of Foreign Offerings, *supra* note 35.

267. *Id.*

268. *Id.*

269. *Id.*

270. See generally STAFF REPORT, *supra* note 3.

271. See Baer, *supra* note 12.

272. STAFF REPORT, *supra* note 3, at Attach. B, p. 7.

273. Schackmann & Barker, *supra* note 16, at 113.

274. Baer, *supra* note 12, at 63-64.