

## THE NEW AND IMPROVED FTC FRANCHISE RULE

By Gayle Cannon

We are all grateful that the FTC has finally revised its rule to more closely align with the UFOC format—disclosures with which we have become comfortable. Many questions have arisen regarding exactly what the new rules require. We want to call the attention of franchisors to just a couple of areas—the changes in the disclosure delivery requirements and the quarterly updating requirements. Also, take a look at the next article, a summary of select items in the new FTC Compliance Guide released on May 9, 2008.

### Timing is everything: Has the 10-Day Rule Really Gone Away?

State Franchise Laws. The amended 2007 FTC Franchise Rule changed the time for disclosure to eliminate the first personal meeting and to change the “10 business days” (the “10 Day Rule”) before consideration is paid or a contract is signed to 14 calendar days. However, a few states have not yet changed their laws or statutes to reflect this change. The states of Michigan, New York, Oregon, Washington and Wisconsin officially still require that franchisors comply with the 10 Day Rule. Wisconsin has proposed an act to revise its disclosure requirements to be consistent with the revised FTC Franchise Rule. The California exemption provisions still refer to delivery of the disclosure document on the “10 Day Rule.”

In our conversations with the offices that enforce these statutes, most have responded that, as an unwritten policy, they will not enforce non-compliance with the 10 Day Rule, assuming a franchisor’s compliance with the 14-calendar day rule. They will follow this policy until their legislatures get around to amending these requirements.

State Business Opportunity Acts. Franchisors in general do not pay much attention to the business opportunity acts in 26 states because most of these acts exempt compliance by franchisors, either because their marketing plans are in association with a federal or state registered trademark or because the franchisor complies with federal or state franchise disclosure laws. Some state business opportunity acts have followed the first personal meeting rule or the 10 Day Rule (or both).

### INDEX

<a href="#">The New and Improved FTC Franchise Rule</a>	1
<a href="#">FTC Releases Franchise Rule Compliance Guide</a>	4
<a href="#">Getting to and from Russia</a>	5
<a href="#">Which Has More Calories: A Big Mac® Or A Chocolate Shake?</a>	7
<a href="#">Around the United States</a>	8
<a href="#">The Effect of the Texas Margin Tax On Franchisors</a>	10
<a href="#">Around the Globe</a>	13
<a href="#">Kudos</a>	13
<a href="#">Publications and Presentations</a>	15

In those states, until the laws are amended, franchisors will have different disclosure delivery requirements than the FTC Franchise Rule requires to remain exempt under applicable business opportunity acts. For example, Oklahoma's business opportunity statute provides for an exemption if the seller complies with the FTC Franchise Rule, but it also includes language requiring delivery of the disclosure under the 10 Day Rule. Connecticut has a similar requirement. Iowa's law exempts those who comply with the FTC Franchise Rule, but still retains the earlier of the first personal meeting delivery requirement or 14 days before a contract is signed or consideration is paid. Franchisors need only be concerned in the non-franchise disclosure/registration states that have business opportunity acts. If you have questions about a particular state with a business opportunity act, please contact us.

### Quarterly Updating

The FTC Franchise Rule has always included a requirement that franchisors update their disclosure documents each quarter, and that requirement remains in the revised 2007 FTC Franchise Rule. The UFOC format does not require quarterly updating, and as long as a franchisor elected to use that format, franchisors had no quarterly updating requirement. Although Maryland and Hawaii require franchisors to file quarterly reports, those reports are not the same as the Franchise Rule requirement. Now that the FTC Franchise Rule will be the format used by franchisors, we hope you will find the information about quarterly updating helpful.

Exactly what does "updating" actually mean? Does this mean that franchisors must re-write their disclosure documents each quarter—a time-consuming and expensive proposition? Well, as with most things, that depends.

The recently released 2007 FTC Compliance Guide provides some answers. The 2007 FTC Franchise

Rule requires that certain information must be current as of the previous fiscal year end. Therefore, for those

items, unless there is a materially adverse change, a franchisor should not have to revise those items quarterly.

### What Items Should You Update?

As a first step, franchisors should add their next quarterly unaudited interim financial statements. The key word in determining whether a disclosure should be included in the quarterly update addendum is "material." The FTC Compliance Guide notes that a "recent filing of a bankruptcy petition or the filing against the franchisor of a legal action that may have a negative effect on its financial condition" are material. Although, the word "material" is used in the quarterly updating section of the FTC Compliance Guide, it is not defined. Indeed, the FTC stated that it did not believe that a definition of "material" was required. The FTC Compliance Guide discusses materiality, in several sections under the individual item disclosures. *In general, any change that would affect a potential franchisee's investment decision or any change that would have a material negative impact on the franchisor's financial condition should be considered material.* Examples include the following:

- ▶ Under Item 3, a litigation disclosure is "material" if the disclosure is "one that is likely to influence a prospective franchisee's investment decision."
- ▶ The FTC Compliance Guide lists as material litigation that would have a material impact on the franchisor if the franchisor did not prevail, such as a claim for which a multi-million dollar civil liability could be imposed.
- ▶ Under Item 10, a change in financing terms would affect the investment decision of a prospective franchisee.
- ▶ Under Item 13, any new or potential litigation or settlements which would limit the use of the franchisor's trademarks is material.

► Under Item 19, a change in the underlying facts of a financial performance representation in the disclosure document should be disclosed in a quarterly update addendum.

► Under Item 20, a change in a franchisor's audited financial statements is material, in which event the franchisor may furnish unaudited financial statements, with a notice that the provided statement are unaudited.

The FTC Compliance Guide points out that certain information need only be updated annually, including the audited financial statements, Item 3 franchisor-initiated litigation, the Item 20 information (*what a relief!!*) and trademark specific franchisee associations. Presumably, because they are not mentioned in the FTC Compliance Guide as requiring updating quarterly, Item 7, Initial Estimated Investment, need not be updated quarterly. We believe that if a franchisor becomes aware that its Item 7 disclosure materially understates the estimated initial investment that the franchisor should update in the quarterly disclosure because such changes would affect a potential franchisee's investment decision.

### Material Changes Under State Franchise Laws and Regulations

As a last caveat, under almost all state franchise laws, franchisors must amend their registrations if a material change occurs. Franchisors should include in their quarterly updates any changes considered material under state franchise laws. Franchisors who amend their disclosures immediately upon knowledge of a material change need not concern themselves with this requirement because they are reporting the change earlier than required by the FTC Franchise Rule.

A few states have defined what constitutes a material change in their regulations. Hawaii and Illinois regulations list as material changes in management, a negative change in the number of outlets within a defined period of time, a franchisor's purchase of more than 5% of franchised outlets in a 3-month period, and commencement of new products lines or

services or changes in the system if more than 20% of sales would be affected. Maryland has an almost similar provision. Minnesota's definition is even more extensive, including changes in fees and other "significant" changes in the system. Wisconsin's regulations include as a material change (in addition to those described above) filing of bankruptcy or default in payment of an obligation that exceeds 5% of total assets if not cured in 30 days. At least in those states, the franchisor should include those changes in the quarterly update addendum. We believe the better practice is to disclose these changes in the quarterly update even where states have not defined what constitutes a material change.

### Where and How Should You Provide Quarterly updates?

Where. The newly released FTC Compliance Guide states that franchisors should add quarterly updates as an addendum to Item 22, Contracts.

Financial Performance Claims Updates. Franchisors who have made a financial performance claim in their disclosure documents have an additional obligation to update. These franchisors must include not only the changes in the quarterly update, but they and their franchise sellers must notify prospective franchisees about any material change in a financial performance representation *even in between quarterly updates*. That notification may be "in any reasonable manner," including letter, telephone call or e-mail.

Internet Disclosures. Franchisors that use the Internet to provide disclosure documents to prospective franchisees may update disclosures at any time. The ability to provide updated disclosures sooner than required in a quarterly update raises a question—for now unanswered—whether a franchisor has a duty to provide notice of a material change earlier than the quarterly update simply because it can. If such a duty is found to exist, a franchisee relying on the Internet disclosure to purchase a franchise before a material change is disclosed might have a claim against a franchisor who does not provide prompt notice of a material change on its Internet disclosures.

Requested Updates by Prospective Franchisees. Prospective franchisees may request an update at any time before they sign the franchise agreement.

If you have questions about quarterly updating requirements under the revised FTC Franchise Rule, contact any of our franchise law attorneys listed at the end of this issue.

---

## FTC RELEASES FRANCHISE RULE COMPLIANCE GUIDE

By Jan Gilbert and Suzie Loonam

On May 9, 2008, the Federal Trade Commission ("FTC") released its long-anticipated Franchise Rule Compliance Guide. The Compliance Guide serves primarily as a concise compilation of key points noted in the Franchise Rule's Statement of Basis and Purpose, the Franchise Rule FAQ's which appear on the FTC's website, and published staff advisory opinions. To a limited degree, the FTC has gone one step further and provided clarification and new insight to select issues raised by the Franchise Rule. Franchisors may be interested in noting the following:

### Business Experience (Item 2)

The Compliance Guide expressly permits disclosure of an individual's business history beyond five years if the prior business experience "is directly relevant to the franchises being offered for sale." The FTC has also shed light on the meaning of "management responsibility" in the context of Item 2, specifying that this includes all individuals, regardless of their formal title, who manage franchise sales or operations to the extent that a prospective franchisee would rely on their expertise, formulation of policy, or control of the system in making an investment decision. While the FTC had previously specified that the formal title of an individual was not pertinent to whether such individual should be disclosed in Item 2, the addition of the explanation should provide useful assistance to franchisors' counsel.

### Litigation Disclosure (Item 3)

With respect to litigation disclosure, the FTC has clarified the materiality standard, focusing on whether the litigation is "likely to influence a prospective franchisee's investment decision." Franchisors should note that the FTC considers "[a]ll suits pertaining to the franchise relationship – even a small number of suits - ... to be material because they may shed light on problems in the franchise relationship or the likelihood that the franchisor will resort to litigation against a franchisee."

Many franchisors have only reluctantly included confidential settlement arrangements in Item 3. The FTC has clarified that franchisors are only required to disclose confidential settlements that they enter into after commencing franchise sales. Thus, if a franchisor entered into a confidential settlement before it established its franchise program, the franchisor is free from having to disclose the matter.

The Compliance Guide also eases the burden on franchisors that must include predecessor litigation by requiring that franchisors make only a "good faith effort" to obtain updates about the predecessor's prior and current litigation. If the franchisor is unable to obtain the updates after making a good faith effort to do so, the franchisor need only indicate this fact in its disclosure document. The FTC has not defined "good faith effort," presumably because such a definition will necessarily be fact-specific.

### Estimated Initial Investment (Item 7)

A franchisor that sold a company-owned outlet in the preceding fiscal year for an amount that exceeds “the highest [Item 7] initial investment for franchised outlets sales... should disclose that fact in a footnote in Item 7. Specifically, the footnote should indicate by how much the sale of company-owned outlets in the preceding fiscal year exceeded the highest initial investment for the sale of a franchised outlet.” Interestingly, such disclosure is required regardless of whether the franchisor intends to sell company-owned outlets on a going-forward basis. Moreover, because initial expenses tend to be specific to the outlet offered for sale and franchisors typically must, as a practical matter, open the books of such outlets to prospective purchasers, one must question the need for and utility of such disclosure. This disclosure obligation will, in effect, require a franchisor to make public the amounts which it charged for a company-owned outlet in excess of its book value (which, in this case, will typically be the book value of the hard assets).

### Confidentiality Agreements Regarding the Operations Manual (Item 11)

The Compliance Guide clarifies that requiring a prospective franchisee to sign a confidentiality agreement before viewing the franchisor’s operations manual will not trigger the disclosure requirement of the Franchise Rule, as such “does not bind the prospective franchisee to purchase the franchise or to undertake other financial obligations, such as the signing of a lease.”

### Public Figure Investments (Item 18)

The Compliance Guide requires disclosure of public figures who invest in the franchisor. This differs from the Franchise Rule, which requires disclosure of the public figure’s investment only if the public figure is involved in the management or control of the franchisor. Hence, even if the public figure has absolutely no involvement in the management or operation of the franchisor and does not endorse the franchises, a franchisor must provide the required disclosure. It is hoped that the FTC will further refine this requirement through a FAQ.

### Media Claims

The Compliance Guide makes great strides in explaining the rules relating to media claims. Whereas the Franchise Rule makes only passing reference to media claims in its definition of “financial performance representations,” the Compliance Guide provides clear direction on the subject. It states, among other things, that the media claim must contain (a) the number and percentages of outlets that attained or surpassed the represented level of performance, (b) the time period when the results were achieved, and (c) a clear and conspicuous admonition that a new franchisee’s results are likely to differ. In addition, the franchisor’s Item 19 must contain full information for the representation provided in the media claim. Such information must appear in Item 19 for at least 6 months after the franchisor ceases making the media claim.

---

## GETTING TO AND FROM RUSSIA

By Leigh N. Ganchan

### New Business Visa Requirement: Getting Your Consultants to your Russian Franchisee for the Opening—and Afterwards.

At the end of 2007, Russia enacted new visa rules to limit the number of days that a business visitor can remain in the country. Multiple entry business visa holders may only remain in Russia in 90 day increments, up to a maximum

of 180 days per year. Those who may have used a business visa to live and work in Russia for extended periods must now obtain a work permit or resident status. These new rules are predicted to impact many business people. Russian work permit application and adjudication can be a time consuming process. We urge employers to review travel plans for expatriates to determine if a work permit might be necessary and if so, to initiate the process at least four months in advance of the assignment in Russia.

### **Getting Your Russian Franchisees to the U.S. for Training.**

The H-3 visa is a nonimmigrant visa which allows foreign nationals to enter the U.S. to receive training at a U.S. company. To qualify for H-3 visa, employees of a Russian franchisee must be coming to the U.S. to receive training. The U.S. company (the franchisor) must first file a petition in the U.S. describing the training program in detail and proving that the franchisee and its employees cannot receive similar training in their home country and that the training will advance their career outside the U.S. The franchisee's interest needs to know that it can get its people to the U.S. to train without running into immigration problems, and the franchisor and the franchisee need to know the process and how long it takes so that the franchisee is able to open up the new franchised business on time and properly.

The franchisor files the petition with the U.S. Citizenship & Immigration Service. Once filed in the U.S., the petition takes 3-4 months under the regular process. If the franchisor or the franchisee pays the U.S. C.I.S. an extra \$1000, they will decide in 15 days. The Consular interview times vary depending on how busy a Consulate is at any given time—anywhere from two weeks to two months or longer. Once the petition is approved, the trainees must submit a visa application to their local U.S. Consulate in Russia and get the visa stamp that allows them to enter the U.S.

Trainees are not allowed to be productively employed in the U.S. unless it is necessary to the training. After admitted to the U.S. in H-3 status, trainees may travel in and out of the U.S. or remain in the U.S. continuously during the validity of the H-3 visa. Trainees may also bring their dependent spouse as well as unmarried children under 21 on an H-4 visa.

### **Visa Processing at U.S. Consulates in Russia**

In 2006, the U.S. Consulate in Moscow issued 85,681 nonimmigrant visas. The U.S. Consulate in St. Petersburg ranked second, issuing 17,390. Still, there are many who encounter difficulties. In fact, the US Consulate in Moscow reports about a 35% denial rate and the other Consulates report even higher denial rates. To exacerbate matters, no one may accompany applicants into the Embassy, not even attorneys or sponsors. Taken together, these facts demonstrate the importance of careful petition assembly and client preparation in advance of the interview.

### **Other Countries.**

The H-3 application for franchisees to train in the U.S. are the same regardless of the country of origin of the trainee. However, visa processing times can differ dramatically among U.S. Consulates, so making advance preparation highly advisable.

Haynes and Boone attorneys in the U.S. and Russia are available to help you navigate the immigration systems in both countries as needed. We can assist in all other countries as well. For more information, contact Leigh at 713-547-2018 or [leigh.ganchan@haynesboone.com](mailto:leigh.ganchan@haynesboone.com).

## WHICH HAS MORE CALORIES: A BIG MAC® OR A CHOCOLATE SHAKE?\*

To make sure you know, New York City took action. Predictably, restaurants resisted. Recently, Haynes and Boone franchise lawyers were asked to comment on a U.S. District Court's ruling in *New York State Restaurant Association v. New York City Board of Health* for an article to appear in "Inside Counsel Magazine." This case involved a New York City code requiring chain restaurants with at least 15 outlets across the country to post caloric content information on their menus and menu boards. We thought you would be interested in the comments of Joyce Mazero, head of our Franchise and Distribution Law Practice Group (in *Italics*).

As background, the New York State Restaurant Association filed a preliminary injunction motion to prevent enforcement of the New York City Health Code Section 81.50, based upon two theories, preemptions and the First Amendment. The First Amendment analysis was that requiring restaurants to disclose caloric contents of menu items forced them to "convey the government's message regarding the importance of calories." The restaurant association argued that the regulation was pre-empted by the federal Nutrition Labeling and Education Act, which gives restaurants discretion and flexibility in whether or how to present nutrition information such as calories. The U.S. District Court rejected the association's motion, and the code was to become effective the next day. The District Court denied the plaintiff's motion to stay enforcement pending an appeal, contingent upon the city's agreement to refrain from imposing fines through July 18. The 2nd U.S. Circuit Court of Appeals could still rule against New York City on the preemption argument depending upon the Food and Drug Administration's opinion on whether FDA rules permit cities to dictate what restaurants must tell customers.

The "Inside Counsel" article considers what this case portends for corporate America in general and the restaurant industry in particular. The article discusses the trend of requiring more disclosure to enable customers to take responsibility for their decisions.

Examples of such laws include cigarette warnings, packaged food labeling, truth-in-menu laws and bans on trans fat. King County, Washington which includes Seattle, enacted a menu labeling rule that affects chain restaurants with 10 or more outlets nationally that have standardized menu items, which becomes effective in August 2008. Those restaurants will be required to list calories on menu boards, and calories, carbohydrates, saturated fat, and sodium on printed menus. Montgomery County, Maryland requires chains with more than 10 locations nationally to include saturated fat and salt content as well as caloric count on menus and menu boards, beginning August 2008 for those chains already required to disclose such information and August 2009 for all other covered chain restaurants. On June 3, a new Santa Clara County, California law requires that chain restaurants in unincorporated areas include nutritional information on menus. Other cities contemplating similar legislation include Chicago, Philadelphia and Washington, D.C., according to a recent article in the Wall Street Journal. The Center for Science in the Public Interest expects more than a dozen state legislatures, including California's and New York's, to consider various menu labeling and trans fat proposals, as are a number of city and county councils.

Inside Counsel: What is your reaction to the 2nd Circuit ruling on appeal?

*Joyce Mazero: The April 29 ruling denied the restaurant association's motion to stay pending appeal, but specifically conditioned the denial on the Board of Health's representation that it will extend the "no fines" period until July 18. In essence, the court brokered a temporary compromise which has an effect comparable to a stay. The court also expedited the appeal and scheduled argument for mid-June, presumably with the expectation that a decision will be rendered before mid-July.*

"Inside Counsel": How do you think these decisions might affect the calorie [disclosure] issue in restaurants/cities across the country?

*Joyce Mazero: I think that we will see more legislation in other jurisdictions requiring greater disclosure of nutritional information. Whether the legislation will serve as a catalyst for the development of healthier menu items is anyone's guess, but I suspect that the restaurant industry will continue its current shift toward healthier menu items, because this is what a major portion of the public wants. It is both good for business and good for the public health.*

"Inside Counsel": With smoking pretty much stamped out in most public places, could obesity and the

calorie postings be the next public-health crusade, as far as restaurants are concerned?

*Joyce Mazero: I think that healthy choices are already a crusade for many restaurant chains and food service companies, because they see an opportunity to participate in and benefit from a major societal change. As a result, Subway has been touting Jared's weight loss, McDonald's has been pushing salads, Kellogg's has shifted to whole grains, and PepsiCo and Coca Cola have been selling bottled water.*

*\* By the way, a Big Mac® has 24 grams of fat and 540 calories, and a medium chocolate milkshake at McDonald's has 10 grams of fat and 390 calories.*

---

## AROUND THE UNITED STATES

**NEWS FLASH:** On June 6, NASAA replaced its 2007 Interim Franchise UFOC Guidelines with its 2008 UFOC Guidelines. The 2008 Guidelines have new filing instructions and new uniform application forms. Illinois has already indicated it will adopt NASAA's new Guidelines. On June 30, 2008, Dale Cantone, **Chair of the Franchise and Business Opportunity Committee/Project Group of NASAA** sent a mass e-mail announcing that as of July 1, 2008, Maryland and other franchise registration states would accept the franchise registration applications that conform to the new NASAA Guidelines, subject to compliance with the state specific requirements.

### THE STATES

#### Oregon

The Department of Consumer & Business Services has proposed a rulemaking action that would change the disclosure requirements under the Oregon Franchise Act to be consistent with the 2007 revised FTC Franchise Rule. The last day to submit written comments was June 23, 2008. The rules would permit the exemptions provided under the FTC Franchise Rule, as well as retaining the exemptions permitted by Franchise Act.

#### Rhode Island Fair Dealership Act

The International Franchise Association claimed a partial victory when the Rhode Island Senate Corporations Committee approved a bill to revise the Rhode Island Fair Dealership Act on June 3, 2008. The Rhode Island Legislature has approved the revision, and the bill awaits the governor's signature. The proposed amendment is a compromise and does not entirely eliminate some of the provisions to which many franchisors most objected. The proposed bill is SB 2595 SubA2.

- deletes references to “substantial change in competitive circumstances” in the notice provision and a statement about a grantor’s inherent “superior economic power and superior bargaining power in negotiations” in the purposes section of the current statute; revises the definition of “good cause” to eliminate language regarding non-discrimination as compared to other similarly situated dealers and added a list of reasons that constituted good cause, including abandonment, a felony offense conviction related to the dealership, material impairment of the grantor’s goodwill, a material misrepresentation relating to the dealership, attempted unauthorized transfers, and insolvency or petition for bankruptcy or assignment for the benefit of creditors;
- reduces the default notice period from 90 to 60 days and the cure period from 60 to 30 days, except for violations of a public health standards, for which the cure period would be 24 hours; and
- permits a dealer to cure three times within a 12-month period.

Left unchanged was a provision that made a dealer’s claim of a violation of the statute “irreparable injury” in determining whether an injunction should issue. The bill is expected to pass because the key parties have agreed to the compromises.

## Texas

### Dram Shop Law Proposed Amendments

Hearings. On May 19, the Texas House of Representatives Committee on Civil Practices heard testimony relating to the Texas dram shop law and the impact of a 2006 Texas Supreme Court case on that law. Dram shop laws impose liability on establishments who sell alcohol to visibly intoxicated persons or minors who subsequently cause death or injury to third-parties, as a result of alcohol-related car crashes and other accidents. We think this is of interest to all restaurant owners in Texas that serve alcoholic beverages.

Background. In Texas the dram shop law contains the exclusive remedies for violation. A 2006 Texas Supreme Court case held that the dram shop laws conflict with the Texas Proportionate Responsibility Statute which would impose liability on the dram shop only if it is found to be more than 50% responsible for the intoxication of the patron. Some proponents of changes want alcohol providers to have liability for the intoxication of the patron, not for its own actions and for providers of alcohol who cause injuries by serving obviously intoxicated patrons to be held jointly and severally liable with the intoxicated patron. Opponents to change argued that alcohol providers should have the same statutory proportionate liability as all other tort defendants now have under current Texas Proportionate Responsibility Statute. In 2007, a similar bill proposed by the Committee on Civil Practices died in the Calendars Committee.

Status. According to staff of the Committee on Civil Practices Committee, this issue is likely to be raised again in the next session of the Texas Legislature in September 2009. Possibilities include an amendment to the current dram shop law or a new bill, which would be included with other items in an omnibus bill. Because of the potential impact on the liability of restaurant and bar owners, staff did not expect this issue to move forward without extensive investigation and discussion.

## New Texas Margin Tax

The more you earn, the less you keep,  
 And now I lay me down to sleep.  
 I pray the Lord my soul to take,  
 If the tax-collector hasn't got it before I wake.  
 ~Ogden Nash

Most of you are aware of the positions of states that franchisors with no physical presence in a state still owe taxes to that state. So that you don't get caught unaware, we asked Jeff Slade to give us the low-down on the new Texas Margin Tax.

## THE EFFECT OF THE TEXAS MARGIN TAX ON FRANCHISORS

By Jeff Slade

The Texas legislature recently enacted legislation that implements a new franchise tax (commonly referred to as the "margin tax") for all tax reports due on or after January 1, 2008. The margin tax is essentially an income tax, subject to certain adjustments described below. Unlike the prior franchise tax, which only applied to corporations and limited liability companies, the new tax generally applies to all entities, including limited partnerships. Accordingly, franchisors and franchisees that are organized as limited partnerships will no longer be exempt from the franchise tax, except as discussed below. The margin tax is a 1% tax (or in certain cases applicable to entities engaged in retail or wholesale trade, the rate is 0.5%) on the "taxable margin" of a taxable entity that does business in Texas.

Calculation of Taxable Margin. An entity's taxable margin is defined as the entity's total revenue, less certain deductions and expenses. "Total revenue" is based upon the entity's federal gross income, after subtracting certain items, such as net distributive income from partnerships or S corporations, items of income attributable to disregarded entities, and foreign royalties and foreign dividends. The entity's taxable margin is equal to total revenue, minus an "adjustment" equal to the greater of: (a) 30% of its total revenue; or (b) at the election of the entity, either its cost of goods sold or compensation. The entity

must pay tax on this amount, multiplied by a ratio equal to the entity's Texas gross receipts, divided by the entity's total gross receipts.

For example, assume a national franchisor operating restaurants has \$1,000,000 of federal gross income, of which \$350,000 is derived from Texas sources. Also assume that the franchisor pays \$500,000 of compensation to its employees located across the country. Under these facts, the franchisor will calculate its franchise tax liability as follows:

Total Revenue:	\$1,000,000	
	<i>-minus-</i>	
Adjustment:		<u>\$500,000</u>
		\$500,000
	<i>-multiplied by-</i>	
Ratio of Texas Receipts:	x	<u>35%</u>
Taxable Margin:		\$175,000
	<i>-multiplied by-</i>	
Tax Rate:	x	<u>1%</u>
<b>Franchise Tax Liability</b>		<b><u>\$1,750</u></b>

Special Rules for Franchisors. In determining if a franchisor is doing business in Texas, and thus subject to tax, the rules are substantially the same as the prior franchise tax. A franchisor is doing business in Texas

if it enters into an agreement with a franchisee that operates in Texas, and under such agreement: (a) the franchisee is granted the right to engage in the business of selling goods or services under a marketing plan or system prescribed by the franchisor; and (b) the franchisee's business is substantially associated with the franchisor's trademark or other commercial symbol of the franchisor. A similar rule, however, does not exist with respect to franchisees. In other words, the franchisor's business operations in its home state are not attributable to the franchisee.

For example, assume Franchisor ABC, a Delaware company, has a franchise agreement with Franchisee XYZ, a Texas company, that prescribes a plan for Franchisee XYZ to sell products using the trademark of Franchisor ABC. Under these facts, Franchisor ABC is subject to the margin tax with respect to any taxable margin that is apportioned to Texas. Franchisee XYZ, as a Texas company, is also subject to the margin tax. Assume instead that Franchisor ABC is a Texas company and Franchisee XYZ is a Delaware company. Franchisor ABC will continue to be subject to the margin tax, but Franchisee XYZ will not be subject to the margin tax unless it conducts some specific activity that creates nexus (*i.e.*, some connection or contact) with Texas.

Combined Group Reporting. One of the major changes under the margin tax is the introduction of combined group reporting, which did not exist under the old franchise tax. There is now less incentive to structure (for tax purposes) a business using several related taxable entities because they likely will be required to file a combined report under the margin tax. Entities that are part of a combined group (*i.e.*, one or more entities engaged in a "unitary business" in which a controlling interest is owned by common owners or one or more of the member entities) must file a single report on behalf of the group. A unitary business is defined as a single economic enterprise made up of a group of entities that is sufficiently interdependent, integrated and interrelated. The determination of whether entities are engaged in a unitary business is a facts and circumstances analysis

that includes, among other factors, whether the group members are in the same general line (*e.g.*, wholesaling, retailing of tangible personal property, etc.) and whether the group members are under centralized management. A controlling interest is defined as owning 50% or more of the stock of a corporation, or 50% or more of the capital or profits of a partnership or limited liability company. All members of a combined group must make the same election with respect to subtracting cost of goods sold or compensation (as described above).

Other Notes and Considerations. Although limited partnerships generally are subject to the margin tax, they are exempt if they are treated as "passive entities" (*i.e.*, greater than 90% of the federal gross income is attributable to certain passive sources such as gains from the sale of securities, interest, dividends, royalties, capital gains from the sale of real estate, etc.). A limited partnership that is a passive entity will not be considered part of a combined group, regardless of any common ownership of the passive entity and any taxable entities.

Certain tax discounts of 20%-100% are available for entities with reduced revenue. For example, entities with total revenue (as calculated above) of \$300,000 or less are exempt from tax. The discount is completely phased out for entities with total revenue of \$900,000 or more, and such entities are subject to the full tax. Under the tax calculation example discussed above, no discount is available because the franchisor's total revenue was \$1,000,000.

An entity with total revenue that does not exceed \$10 million may elect to use an "E-Z" computation, under which the entity may use a 0.575% tax rate (instead of 1%), multiplied by its total revenue (as calculated above) and apportioned to Texas based on its Texas gross receipts (as described above). Under the "E-Z" computation, the entity may not take a deduction for compensation, cost of goods sold, or the 30% reduction described in the second paragraph above.

However, the 20%-100% tax discounts above are still applicable to taxpayers electing to use the "E-Z" computation. Under the tax calculation example discussed above, the franchisor would not benefit from the "E-Z" computation, yielding a tax liability of \$2,012.50 (\$1 million, multiplied by 35%, multiplied by 0.575%) versus \$1,750 (due to the \$500,000 compensation deduction under the standard calculation).

Finally, because there generally is no distinction between limited partnerships and limited liability companies under the margin tax, franchisors and

franchisees that were previously formed as limited partnerships may choose to convert to limited liability companies if the limited partners desire to participate in the management of the company without risking their limited liability protection under state law.

Jeff is an associate in the Business Planning & Tax group of Haynes and Boone, LLP and can be reached directly at (972) 739-8608 or [jeff.slade@haynesboone.com](mailto:jeff.slade@haynesboone.com).

---

## FEDERAL

### Resale Price Maintenance: *Leegin Creative Leather Products v. PSKS, Inc.*,

by Veronica Kayne

On May 6, 2008, the FTC announced its first ruling in a resale price maintenance ("RPM") case since the US Supreme Court ruled in *Leegin* that minimum resale pricing was permitted under certain circumstances. Nine West (manufacturer of women's shoes) was engaged in resale price maintenance and signed a consent agreement with the FTC in which it agreed not to use RPM anymore. After *Leegin*, Nine West petitioned the FTC to modify the order so that it could engage in RPM, just as its competitors could. The FTC has just modified the order so that it doesn't prohibit Nine West from using RPM. A quick read of the order indicates that the FTC was not impressed with Nine West's arguments that RPM would be pro-competitive. On the other hand, because of Nine West's small market share, the FTC wasn't convinced that RPM would necessarily be anticompetitive; it relied on the idea that other competitors would constrain Nine West's pricing. The FTC, therefore, decided to permit Nine West to engage in RPM but required it to report back at regular intervals on the effects of the RPM program on prices and output.

### Update on FACTA

#### President Signs the Credit and Debit Card Receipt Clarification Act

We explained the federal Fair and Accurate Credit Transaction Act (FACTA) to you in our Fall 2007 issue. The law required retail businesses to use only the last digits of card numbers and not to include the expiration date on consumer receipts to help prevent credit card fraud. One of the glitches in the law made it unclear if a retailer would be liable if it used no more than 5 numbers of a credit card number, but included the expiration date. Several lawsuits were filed against retailers for willful violation of FACTA because they had not deleted the expiration date of a credit card. During May, both the House and the Senate unanimously approved an amendment that would protect those retailers who had been sued before the amendment becomes law, except when a consumer suffered identity theft or account fraud arising from a retailer's negligent handling of the receipt. On June 5, the President signed the amendment to clarify FACTA.

## AROUND THE GLOBE

### China

Franchisors interested in franchising in China have been anxiously awaiting interpretations from the Chinese Ministry of Commerce (MOFCOM) whether they could meet the "2 for 1 requirement" of the new Chinese franchise law through development by an affiliate. Under the "2 for 1 requirement," to be eligible to franchise in China, a franchisor must operate at least two directly operated shops, and the period of operation must be for more than 1 year. Previously, MOFCOM had clarified that these two operations could be outside of China. We have now heard that new rules should be released shortly, if not already, that will clarify that satisfaction of this requirement may be through an affiliate of the franchisor. As late as last April, MOFCOM appeared to back off from such a policy pending State Council review.

### Indonesia

The scuttlebutt is that the long-awaited implementing regulations for the new disclosure obligations and other franchise requirements in Indonesia will be released in July 2008. We will keep you posted.

---

## KUDOS

### CHAMBERS USA 2008 RANKINGS

We have to toot our own horn!! Chambers USA 2008 rankings released on June 13 confirmed that Haynes and Boone is one of the highest ranked firms in Texas. Our Franchising and Bankruptcy practice groups ranked in the top band nationally. Chambers listed 33 Haynes and Boone attorneys in the top bands state-wide. Special kudos are due to Joyce Mazero, who ranked in the national first band in Franchising (moving up from band 2) and Deb Coldwell who maintained her national third band ranking, and to the Franchise Practice Group, which maintained its national band two ranking. Chambers & Partners is a respected legal research publication which ranks firms and attorneys after interviewing peers, competing law firms, and significant purchasers of legal services. Other practice groups of interest to our franchisor clients that Chambers ranked highly include Bankruptcy/Restructuring, Antitrust, Insurance, Real Estate, Environment, General Commercial Litigation, Corporate/Mergers & Acquisitions, Technology & IT Outsourcing, Banking & Finance, Intellectual Property, Labor & Employment and Energy & Natural Resources.

## DOMINO'S WINS!! *BORES V. DOMINO'S PIZZA, LLC*

**"You may purchase items meeting our specifications from any source."  
Section 8.2, Domino's franchise agreement.**

Haynes and Boone franchise experts, Joyce Mazero and Deb Coldwell, along with appellate lawyer, Anne Johnson, partnered with several other well-known law firms in obtaining a tremendous result for Domino's. The case turned on the interpretation of the section above from Domino's franchise agreement.

Domino's mandated that its franchisees install its proprietary PULSE hardware and software by June 30, 2008. Some franchisees refused to install PULSE. They insisted that Domino's provide them with "specifications" for PULSE and that they could purchase the computer hardware and software meeting those specifications from any source. Several franchisees filed suit against Domino's.

The Minnesota federal district court interpreted "from any source" to mean that Domino's could not force its franchisees to buy its proprietary Pulse software only from Domino's and the PULSE hardware only from IBM, and granted the franchisees' motion for summary judgment. On appeal, the U.S. Eighth Court of Appeals reversed, agreeing with Domino's that the district court's interpretation of "specification" was unduly restrictive. In their analysis, both of the courts went to the dictionaries—in fact, the Eighth Circuit went to several of them—for definitions of "specification" and "any source." The Eighth Circuit concluded that the word "specification" could refer to a "single item or article that has been specified," as well as a "written description for the manner and process of making, constructing, compounding and using an item," and that the word "any" could mean "[o]ne, some, every, or all." Therefore, Domino's could require its franchisees to buy PULSE software only from Domino's and PULSE hardware only from IBM.

The parties litigated for more than two years, and according to the district court's opinion, with "increasing acrimony." The Eighth Circuit ultimately reversed the summary judgment granted by the district court and remanded with instructions to enter a take-nothing judgment in favor of Domino's.

## RECENT VICTORIES FOR CLIENT ROLY POLY FRANCHISE SYSTEMS, LLC

Roly Poly Franchise Systems, LLC has been a loyal client of the Firm, and our litigation team has obtained two great victories for Roly Poly recently. In July 2005, former master developer and franchisees Summers-Wood, L.P., Summers-Wood Management, L.L.C., John Summers and J. Michael Wood (collectively, the "S-W Parties") sued Roly Poly and another franchisee in state court in Collin County, Texas. In addition, the S-W Parties improperly sued Roly Poly's president and vice president Linda Wolf and Julie Reid.

Wolf and Reid filed special appearances, objecting to the Court's exercise of personal jurisdiction over them. Wolf and Reid are not Texas residents. Wolf and Reid's only contacts with Texas arose out of actions they took in their capacity as officers for Roly Poly. Thus, Wolf and Reid were protected by the fiduciary shield doctrine. Despite their evidence and supporting case law, the 401st District Court denied Wolf and Reid's special appearances. Wolf and Reid appealed.

Wolf and Reid appealed to the Court of Appeals for the Fifth District of Texas at Dallas that the trial court lacked general and specific personal jurisdiction over Wolf and Reid. In addition to the briefing, Ben L. Mesches presented oral argument before the Court of Appeals, contending that the appellate court should reverse the trial court's denial of Wolf and Reid's special appearances. Our attorneys successfully persuaded the Court of Appeals. In January

2007, the Court of Appeals reversed the trial court's denial of Wolf and Reid's special appearances and rendered a judgment of dismissal as to Wolf and Reid individually. The Court of Appeals found that the trial court did not have personal jurisdiction over Wolf and Reid. The Court of Appeals agreed that Wolf and Reid's contacts with Texas were made in their corporate or representative capacities and their individual contacts with Texas were neither continuous nor systematic.

The S-W Parties' then filed a second lawsuit against Wolf and Reid, individually, on January 17, 2008. The S-W Parties filed nearly an identical lawsuit—same "facts" and claims. This time, the S-W Parties filed against Wolf and Reid in state court in Escambia County, Florida, where the only connection was that Escambia County was the residence (and place of business) of the S-W Parties' attorney.

After removing the case to the federal court in the Northern District of Florida based on diversity of citizenship, Wolf and Reid argued that the Northern District of Florida was improper and inconvenient because: (i) neither Wolf nor Reid resided (or had resided) in the Northern District of Florida; (ii) no events or omissions giving rise to the claims occurred in the Northern District of Florida; and (iii) the action may have been brought in the District of Connecticut. The Court agreed with Wolf and Reid.

On May 23, 2008, the Northern District of Florida issued its Order granting Wolf and Reid's transfer to the District of Connecticut. The Court reasoned that, among other things, (i) no witnesses resided in or near the Northern District of Florida, (ii) no events related to the case occurred in that district; (iii) the convenience of the parties "strongly" favored transfer, and (iv) the location of the S-W Parties' counsel was entitled to the least consideration. Therefore, the Court ordered that the case would be transferred to the District of Connecticut and that all other pending motions were carried with the case. Haynes and Boone, with the assistance of local counsel, obtained another victory for Roly Poly's officers Wolf and Reid.

## PUBLICATIONS AND PRESENTATIONS

### *IFA Legal Symposium: May 11-13, 2008, Washington, DC*

- Jan Gilbert - Moderator on Basics Track - Registration – "Understanding the State Franchise Registration Framework and How the Amended FTC Franchise Rule Will Impact It"
- Rob Lauer - Roundtable Moderator – "Notices of Default and Termination: How to Enforce Franchisee Exit from the System"
- Joyce Mazero - Roundtable Moderator – "Advanced Issues in Mergers and Acquisitions"
- Carl Zwisler – "Strategies in International Expansion"
- Carl Zwisler – "Elements of Successful International Master Franchising"

Carl Zwisler, Canadian Franchisors Benefit from New U.S. Trade Rule, *The Lawyers Weekly*, 1/25/2008.

Carl Zwisler, "From Brazil to the United States: Franchising in The USA," *The USA Brazilian Pavilion Business Seminar*, 2/8/2008,

Carl Zwisler, "The Basics of International Master Franchising," *IFA Annual Convention*, 2/10/2008,

Carl Zwisler, "FTC Franchise Director's Departure Very Untimely," *IndUS Business Journal*, 4/1/2008

### *International Franchise Expo: April 11-12, 2008*

- Carl Zwisler – "Planning for Master Franchising"

Carl Zwisler, "Franchising In China: How to Do It Under the New Regulations," *American Bar Association Teleseminar*, 4/9/2008

If you have any questions, please contact one of the following Haynes and Boone attorneys.

**Austin, Texas:**

**Gayle Cannon**

Phone: 512.8437

[gayle.cannon@haynesboone.com](mailto:gayle.cannon@haynesboone.com)

**Rob Lauer**

Phone: 512.867.8505

Fax: 512.867.8675

[rob.lauer@haynesboone.com](mailto:rob.lauer@haynesboone.com)

**Susie Loonam**

Phone: 512.867.8417

[susie.loonam@haynesboone.com](mailto:susie.loonam@haynesboone.com)

**Hal Sanders**

Phone: 512.867.8427

[hal.sanders@haynesboone.com](mailto:hal.sanders@haynesboone.com)

**Dallas, Texas:**

**Jeff Becker**

Phone: 214.651.5066

[jeff.becker@haynesboone.com](mailto:jeff.becker@haynesboone.com)

**Deborah S. Coldwell**

Phone: 214.651.5260

[deborah.coldwell@haynesboone.com](mailto:deborah.coldwell@haynesboone.com)

**Ryan Cox**

Phone: 214.651.5273

[ryan.cox@haynesboone.com](mailto:ryan.cox@haynesboone.com)

**Joyce G. Mazero**

Phone: 214.651.5336

[joyce.mazero@haynesboone.com](mailto:joyce.mazero@haynesboone.com)

**Altresha Burchett**

Phone: 214.651.5258

[burcheta@haynesboone.com](mailto:burcheta@haynesboone.com)

**Alberto de la Peña**

Phone: 214.651.5618

[delapena@haynesboone.com](mailto:delapena@haynesboone.com)

**Aimee Minick**

Phone: 214.651.5024

[aimee.minick@haynesboone.com](mailto:aimee.minick@haynesboone.com)

**Purvi Patel**

Phone: 214.651.5917

[purvi.patel@haynesboone.com](mailto:purvi.patel@haynesboone.com)

**Houston, Texas:**

**Leigh Ganchan**

Phone: 713.547.2018

[leigh.ganchan@haynesboone.com](mailto:leigh.ganchan@haynesboone.com)

**Mexico City:**

**Agustin Portal**

Phone: 52.55.55.40.5558

[Agustin.Portal@haynesboone.com](mailto:Agustin.Portal@haynesboone.com)

**Moscow:**

**Michael Malloy**

Phone: +7 495.643.1715

[michael.malloy@haynesboone.com](mailto:michael.malloy@haynesboone.com)

**Washington, DC:**

**Jan Gilbert**

Phone: 202.654.4542

[jan.gilbert@haynesboone.com](mailto:jan.gilbert@haynesboone.com)

**Carl E. Zwisler**

Phone: 202.654.4540

[carl.zwisler@haynesboone.com](mailto:carl.zwisler@haynesboone.com)

This newsletter is for informational purposes only and is not intended to be legal advice. Transmission is not intended to create and receipt does not establish an attorney-client relationship. Legal advice of any nature should be sought from the legal counsel. For more information about Haynes and Boone and our practice, please visit [www.haynesboone.com](http://www.haynesboone.com)