RECENT CHANGES TO THE FTC BUSINESS OPPORTUNITY RULE: A TRAP FOR THE UNWARY

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This article provides a detailed overview of the provisions of the new federal "FTC Business Opportunity Rule", which came into effect on March 1, 2012 and in principle applies to franchises and similar systems. Most foreign franchise systems interested in expanding into the U.S. market will likely fall within the relatively broad scope of federal and state franchise laws and will therefore be exempt from application of the federal and state business opportunity laws. However, especially for those foreign businesses that are looking to avoid being classified as a franchise and the disclosure obligations that accompany that classification, the business opportunity laws are very important. While the new rule remains narrower in scope than many state business opportunity rules, it significantly broadens the scope of federal law and provides one more layer of legislation that lawyers and their clients have to contend with when analyzing the regulatory network a business will be subject to when entering the U.S. market.

It should come as no surprise to the readers, whether they are U.S. attorneys or licensed in other jurisdictions, that in the U.S. there are both federal and state franchise laws and regulations. What many non-U.S. practitioners are likely less familiar with is the other set of federal and state laws and regulations that often apply to franchises and similar systems: the business opportunity laws.[1] The federal business opportunity rule (the "FTC Business Opportunity Rule") has been significantly revised, and the new rule comes into effect on March 1, 2012.[2]

Generally speaking, a business opportunity is a franchise, less the trademark association, plus some type of assurances of success or safety net by the seller. The state law definitions of a "business opportunity" are not uniform, though they are similar. The definition under the Indiana business opportunity law is fairly typical:

[1] As is explained below, franchises are usually exempt under both state, and under the new federal business opportunity laws.

[2] 16 C.F.R. 437 (2011).

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"Business opportunity" means an investment that:

1. involves the sale or lease or offer to sell or lease any goods or services to an investor that are to be used by the investor in beginning or operating a business;

2. involves an initial payment by the investor of more than five hundred dollars ($500) and an initial cash payment of less than fifty thousand dollars ($50,000); and

3. involves a solicitation of investors in which the seller represents that:

   (a) the investor may or will earn an amount in excess of the initial payment as a result of the investment;

   (b) a market exists for any goods to be made or services to be rendered by the investor;

   (c) the seller may buy from the investor any goods to be made or services to be rendered by the investor;

   (d) the seller or a person referred by the seller to the investor may or will sell, lease, or distribute the goods made or services rendered by the investor; or

   (e) the seller may or will pay to the investor the difference between the initial payment and the investor's earnings from the investment.[3]

It is for good reason that non-U.S. franchise lawyers may not be familiar with the business opportunity laws. Even though 25 of the U.S. states have such laws, a typical franchise system is usually exempt as long as it has a federally registered trademark.[4]

If there is good reason for non-U.S. franchise lawyers to not being familiar with state business opportunity laws there has been even more reason not to be familiar with the federal business opportunity rule. Historically, the federal business opportunity rule had such a narrow scope that it rarely applied even to businesses that clearly fell within the state business opportunity definitions. It focused on business opportunities that the FTC records showed were most likely to result in significant consumer injury. These included business opportunities involving vending machines, rack displays and other product displays.

The new rule, while still narrower in scope than many state business opportunity rules, significantly broadened the scope of federal law. A business opportunity is defined under the new rule as:

> *Business opportunity* means a commercial arrangement in which:
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> (1) A seller solicits a prospective purchaser to enter into a new business; and
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> (2) The prospective purchaser makes a required payment; and
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> (3) The seller, expressly or by implication, orally or in writing, represents that the seller or one or more designated persons will:
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> (i) Provide locations for the use or operation of equipment, displays, vending machines, or similar devices, owned, leased, controlled, or paid for by the purchaser; or

[3] Indiana Code, 24-5-8-1. The Indiana definition is somewhat unusual in that it covers not only the start of a business, but also the operations of a business. Usually, state business opportunity laws only cover the start of a new business. This is a material distinction for some franchise systems, such as systems operating as fractional franchises. Those franchise systems, by definition, sell their franchises to prospects that are already in the same type of business as the franchise being offered and the franchise is an "add-on" to the prospect's existing business. Fractional franchise systems can often avoid state franchise laws, and can avoid most business opportunity laws because the buyer is not starting a new business.

[4] Most state business opportunity statutes exempt franchises that comply with the state or federal franchise laws. In a few states – Florida, Kentucky, Nebraska, Texas, and Utah, simple one-time or recurring filings are necessary, but these are usually done in connection with the franchise filings. If the franchise system trademark has not been registered additional business opportunity statutes may have to be reviewed and complied with. It should be noted that for franchise systems relying on exemptions to avoid disclosure the state business opportunity statutes have to be carefully reviewed to ensure that the statutory franchise exemption still applies.

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(ii) Provide outlets, accounts, or customers, including, but not limited to, Internet outlets, accounts, or customers, for the purchaser's goods or services; or

(iii) Buy back any or all of the goods or services that the purchaser makes, produces, fabricates, grows, breeds, modifies, or provides, including but not limited to providing payment for such services as, for example, stuffing envelopes from the purchaser's home.[5]

Thus, while the FTC Business Opportunity Rule is still focusing to a large extent on vending machines and similar opportunities, it has been significantly expanded since subsection (3)(iii) of the above definition applies to business opportunities where the seller promises to buy back goods or services from the purchaser.

However, if the new FTC Business Opportunity Rule throws a broader net and captures business opportunities that were previously outside of the scope of federal regulation, the disclosure obligations that business opportunities are subject to under the federal rule have been made significantly lighter. Previously, business opportunities within the scope of the old rule had to prepare disclosure documents that in many ways mimicked the federal franchise disclosure obligations. Under the new rule disclosure is much simplified. The FTC has prepared a one-page form with five information categories that the business opportunity seller has to respond to. Depending on the business opportunity terms, the federal disclosure document may be just that one page, though attachments may sometimes be necessary. Below, after explaining the background to the new rule and discussing some of the contentious provisions in it, we will review disclosures required under it.

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Background to the revised FTC Business Opportunity Rule

As discussed above, the original FTC Business Opportunity Rule was narrow in scope. It focused on the types of business opportunities that the FTC had found were most frequently fraught with fraud and where consumer injury was the greatest. Those business opportunities were made subject to the original rule and rather significant disclosure obligations were imposed on them. When the FTC reviewed the rule in the late 1990s, it found that the rule imposed unnecessary compliance cost on the business opportunity sellers subject to the rule, and at the same time was not broad enough in scope. In addition to vending machine and display rack schemes, the FTC found that many fraudulent business opportunities involved work-at-home schemes such as envelope-stuffing, product assembly, and medical billing.[6] Consequently, through the rulemaking process leading up to the adoption of the new FTC Business Opportunity Rule, the FTC set out to find a better balance – a rule that covered those types of business opportunities it believed posed the greatest dangers to consumers, and at the same time did not impose overly ardent disclosure obligations on business opportunities.

[5] 16 C.F.R. 437.1(c).

[6] A 2005 consumer fraud survey conducted by the FTC indicated that 2.4 million individuals experienced work-at-home fraud. *See* Consumer Fraud in the United States: The Second FTC Survey (October 2007) at 22.

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Objections to the revised FTC Business Opportunity Rule

In 2006 the FTC published an Initial Notice of Proposed Rulemaking which included a new draft business opportunity rule. The draft was in many respects similar, or identical to the rule that was finally adopted, but some of the draft provisions were not well received by all. In particular, the multi-level marketing ("MLM") industry was very concerned that MLM companies would be swept under the new rule. More than 17,000 comments were sent to the FTC, most of which came from representatives for MLMs. While several aspects of MLMs differ from franchise systems, the basic legal aspects of MLMs are similar to franchises: MLM buyers get the right to sell products under a specific trademark, and they get training and assistance in how to sell those products. Franchise laws are usually avoided because initial payments do not qualify as required payments.[7] The new FTC Business Opportunity Rule has no minimum dollar threshold.

The FTC decided that it was unnecessary to sweep MLMs under the FTC Business Opportunity Rule. This is not to say that fraud and unfair trade practices never happen within the MLM business format. The FTC only concluded that requiring disclosures would not help consumers distinguish between the many legitimate MLM operators and those whose systems involve fraudulent pyramid schemes and that it would instead continue its enforcement against abuse in the MLM industry under Section 5 of the FTC Act.[8] The issues raised by the MLM industry, however, highlight some of the more interesting aspects of the FTC Business Opportunity Rule.

"Business Opportunity"

There are three elements to the business opportunity definition under the FTC Business Opportunity Rule.

- First, the buyer must be entering into a new business.
- Second, the buyer must make a required payment.
- Third, the seller must be providing the buyer with some type of assistance, such as providing locations for vending machines or display racks, or providing outlets or customers for the products or services to be sold, or there must be a promise made to buy back goods or services made, produced, fabricated, grown, bred, modified or provided.

Initially, the rule was also supposed to cover assistance consisting of tracking or paying commissions or other compensation based on the buyer's sale of goods or services or recruitment of others to sell goods or services. It was primarily these additional types of "assistance" that got the MLM industry up in arms. The FTC found that these forms of assistance would indeed provide too broad a coverage and decided to remove them from the business opportunity definition.

The MLM industry had one more major concern with the business opportunity definition under the rule. The second concern focused on the word "provide" in subsection 3 (iii) of the definition. Most MLM participants do not make, produce, fabricate, grow, breed, or modify goods or services, but they do in a sense provide for sale the products manufactured or sold by the MLM. The Direct Selling Association ("DSA"), the industry organization for the MLM industry, requires that its members offer to buy back at 90% of the MLM participant's cost, all resalable inventory and sales materials. Consequently, the business opportunity definition would create a sort of catch

[7] Required purchases to enter into an MLM business are usually set below the state and federal minimum dollar thresholds for required payments.

[8] F.R. Vol. 76, No. 236, December 8, 2011, 76822-24.

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22 for MLMs – if they were to comply with the DSA rules, they would automatically become subject to the FTC Business Opportunity Rule. The FTC decided to leave the word "provide" in Section 437.1(c)(3)(iii), but explained that the section was not intended to capture repurchase of unused inventory purchased from the seller.[9]

The sections of the disclosure document

At the initiative of the MLM industry the scope of the rule was therefore limited. However, reviewing the disclosure requirements under the rule, one may wonder why the MLM industry was so concerned about being subject to the FTC Business Opportunity Rule. There are only five sections in the disclosure document and, at least for a franchise lawyer used to the FDD, the information to be provided is both obvious and minimal.

Identifying information

The first category of information is the most basic contact information imaginable: the business opportunity seller must disclose its name, business address, and telephone number. If this is contrasted with the identifying information required of a franchisor, the compliance burden for business opportunity sellers is indeed much lighter. Franchisors have to disclose information not only about themselves, but also about affiliates and parents, and disclose information about affiliated franchise systems, the competitive environment of the franchise, and specific laws applicable to the franchise.

Earnings claims

When the FTC revised the FTC Franchise Rule it replaced the old terminology of "earnings claims" with the phrase "financial performance representation". For some reason when revising the FTC Business Opportunity Rule, it decided to keep the old terminology. Aside from this difference in terminology, the basic definitions are substantially similar. An "earnings claim" under the FTC Business Opportunity Rule is defined as follows:

> *Earnings claim* means any oral, written, or visual representation to a prospective purchaser that conveys, expressly or by implication, a specific level or range of actual or potential sales, or gross or net income or profits. Earnings claims include, but are not limited to:
>
> (1) Any chart, table, or mathematical calculation that demonstrates possible results based upon a combination of variables; and
>
> (2) Any statements from which a prospective purchaser can reasonably infer that he or she will earn a minimum level of income (*e.g.,* ''earn enough to buy a Porsche,'' ''earn a six-figure income,'' or ''earn your investment back within one year'').[10]

Just as under the FTC Franchise Rule earnings claims are permitted, but not required. A business opportunity seller who doesn't make an earnings claim simply has to check a box "no" on the disclosure document. A seller who makes an earnings claim checks the box "yes" and must attach the earnings claim to the disclosure document.

Legal actions

The type of legal actions that are the most likely to impact a buyer's decision whether to invest in a business opportunity have to be disclosed. This includes civil and criminal actions within 10 years before the date of the disclosure. It is actions involving the business opportunity seller, its affiliates, other prior businesses of the seller, as well as of officers, directors, sales managers and individuals that perform the same functions, but may not hold such titles. An interesting aspect of this

[9] *Id*. at 76832.

[10] 16 C.F.R. 437.1(f).

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disclosure is that the case summaries may not be longer than 100 words each.

Cancellation and refund policies

The FTC has found that many business opportunity sellers will promise buyers that they will receive their money back or some other type of refund if they are unhappy with the business opportunity. However, either they never make good on such promises, or the conditions for receiving a refund or having an agreement cancelled are such that in practice it is impossible to receive the promised recourse. Therefore, business opportunity sellers who make such promises must include the material terms of the refund or cancellation policies in an attachment to the disclosure document.

References

As franchisors are required to provide a list of their franchisees, business opportunity sellers too must provide contact information of their buyers. As with the other categories of information, this disclosure obligation is less than what franchisors have to provide. The business opportunity seller only has to provide the name, state, and telephone number of their buyers. They also don’t have to provide all buyers – only those who purchased the business opportunity in the last 3 years.

Separate State and Federal disclosure document

Just like with the FTC Franchise Rule,[11] the FTC has refused to preempt state law, other than those state laws that offer business opportunity buyers lesser protections than the FTC Business Opportunity Rule. Leaving aside the wisdom of that decision and the federal government’s powers to preempt state law, this causes some issues for a business opportunity seller. The FTC has been very clear that additional disclosures beyond the five categories required by the federal rule may not be added to the disclosure document, and that the federal disclosure document may not be made part of state business opportunity disclosure documents. As a result, in those states that require business opportunity sellers to provide a disclosure document under state law, sellers who fit both the federal and state business opportunity definitions will be required to provide prospective buyers with two disclosure documents – a state document and the federal one.

Foreign language disclosure

From an international perspective, one of the more interesting aspects of the FTC Business Opportunity Rule is that the disclosure language will not always be English. Recognizing that certain business opportunities will target specific ethnic groups the FTC now mandates that the disclosure document be provided to prospective buyers in the same language as in which the offer was made. To that end, the form disclosure document that is part of the FTC Business Opportunity Rule is provided not only in English, but also in Spanish. However, if the offer is made in another language than English or Spanish, the business opportunity seller would be required to translate the form into such other language.

Express prohibition against misrepresentation

The FTC Business Opportunity Rule also expressly prohibits business opportunity sellers from making several types of misrepresentations. The author in her humble opinion thought misrepresentations in general should be avoided, but apparently several types of misrepresentations are common enough that the FTC thought it prudent to prohibit them expressly. They include:

- Misrepresentations regarding the amount of sales, income or profits that the buyer may earn or other buyers have earned;
- Misrepresentations regarding the costs, performance, or nature of the business opportunity;
- Misrepresentations regarding the assistance offered to the buyer; and
- Stating that government entities, laws, or regulations prohibit the seller from disclosing the identity of other buyers or providing earnings information to the buyer.

[11] 16 C.F.R. 436 (2007).

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"The broadening of the FTC Business Opportunity Rule does not impose a significant administrative burden, but it could nonetheless be a trap for the unwary."

Most franchises excluded

As mentioned above, the state business opportunity law definitions cover many franchises and those laws therefore contain exemptions for concepts that are regulated under state and federal franchise laws. The FTC Business Opportunity Rule faces the same problem and just like the state laws, the federal rule also contains a franchise exemption.[12] However, the FTC Business Opportunity Rule and the FTC Franchise Rule are at odds in two regards: the FTC Franchise Rule exempts from its application those franchises where the required payment payable by the franchisor within the first 6 months after commencing operation is less than $500. The FTC Business Opportunity Rule has no minimum payment exemption. The FTC Franchise Rule also exempts those arrangements that are completely oral, while the FTC Business Opportunity Rule does not distinguish between written and oral agreements. The conflict was resolved by exempting franchises subject to the FTC Franchise Rule from the FTC Business Opportunity Rule, except for those that are exempted from the FTC Franchise Rule because of the minimum payment or the oral agreement exemptions. As a result, those franchise systems that have been avoiding the FTC Franchise Rule by keeping initial fees below $500 or not charging fees above $500 until after 6 months of operations will carefully need to review the FTC Business Opportunity Rule to ensure that they are not now subject to the federal rule.

Conclusion

Most foreign franchise systems interested in expanding into the U.S. market will likely fall within the relatively broad scope of federal and state franchise laws. As such, the federal and state business opportunity laws may be of little consequence to them. However, especially for those foreign businesses that are looking to avoid being classified as a franchise and the disclosure obligations that accompany that classification, the business opportunity laws will be very important. The broadening of the FTC Business Opportunity Rule does not impose a significant administrative burden, but it could nonetheless be a trap for the unwary. As with the FTC Franchise Rule there is no private cause of action, but the rule would fall under the so called state "Little FTC Acts" which do provide a private cause of action. At the end of the day, the FTC Business Opportunity Rule now provides one more layer of legislation that lawyers and their clients have to contend with when analyzing the regulatory network a business will be subject to when entering the U.S. market.

[12] 16 C.F.R. 437.8.

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