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Dale Cantone, Chair
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200 St. Paul Place, 20th Floor
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Sent by email to: dcantone@oag.state.md.us

Re: Starbucks Corporation Comments on Proposed Model Franchise Exemptions

Dear Mr Cantone:

Thank you for the opportunity to respond to NASAA's proposed model franchise exemptions. As background, Starbucks Corporation currently licenses operating rights for retail coffee stores and kiosks under the Starbucks brand in the United States through exemption-based franchising, and has approximately 4,000 U.S. licensed stores now operating, in addition to approximately 6,500 U.S. company-operated stores. Also, Starbucks subsidiary Seattle's Best Coffee, LLC franchises the SBC brand in the United States through both exemption-based and disclosure-based franchising.

We commend NASAA's efforts to craft a more uniform set of exemptions to state franchise laws, and to bring those exemptions more in line with the standards established by the federal Franchise Rule. In Starbucks experience, the current lack of uniformity and consistency among state law adds significant amounts of time and administrative cost to exemption-based licensing, and the resulting frustration is largely visited on franchisees who are clearly qualified to operate and who squarely fall within an exemption under the federal rule.

We will divide our comments on the proposed model exemptions into four categories: (1) the scope of the exemption provided (i.e., exemption from registration alone vs. exemption from both registration and disclosure); (2) the scope of affiliates and operations that may be considered for purposes of qualifying for exemptions; (3) the "same type of business" standards; and (4) miscellaneous issues.

1. The scope of exemption provided

The proposed model exemptions mostly parallel exemptions provided under the federal Franchise Rule. Of course, the Franchise Rule contains no registration requirement, so a federal exemption means that there is neither a registration nor a disclosure obligation for an exempt transaction.

Under the proposed state exemptions, however, the consequence of being "exempt" varies between exemption from registration alone, and exemption from both registration and

disclosure. The proposed exemptions cover both registration and disclosure for fractional franchises and franchisor insiders, but cover only registration for existing franchisees, sophisticated franchisees/accredited investors, substantial investments, and experienced franchisors (the last of these is the only category without a direct parallel under the federal rule). We respectfully propose that all of the exemptions should cover both registration and disclosure, which would bring these exemptions directly in line with the exemptions under the Franchise Rule.

This distinction has significant consequences for exemption-based franchising. In Starbucks case, because we engage only in exempt relationships, we do not have (and have never had) a franchise disclosure document, which the FTC has deemed unnecessary because of the size, sophistication, experience, and capitalization of Starbucks licensees. For those franchisors who do have an FDD or have previously sold disclosure-based franchises, it is a time-consuming and costly effort to update and maintain those documents, and that time and expense often overshadows the time and expense required to obtain a state registration. A disclosure requirement undermines much of the utility and value of an exemption from registration, and where the FTC has deemed disclosure unnecessary and the state has deemed registration unnecessary, it follows that a disclosure requirement is unnecessary and unduly burdensome.

2. The scope of the affiliates and operations considered

Many franchisees who qualify as exempt are part of complex corporate organizations with an array of related parent, subsidiary, and affiliate entities, and the franchisee entity itself may engage in a variety of operations that are not directly related to the franchised business. In the proposed exemptions, there are opportunities to clarify the extent to which those related corporate entities may be considered, and the scope of the other business activities that should be included in the franchisee's financial metrics.

Under the fractional franchise exemption, section 1(a)(ii) establishes that the "sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation." We suggest that the provision should clarify:

- How to apply this provision in the instance of a multi-unit "relationship". In particular, whether only the year following execution of the contract is relevant to this equation, and franchised units developed in later years are to be ignored; or alternatively, whether each unit should be evaluated in its first year of operation, but other units previously established by that franchise under the same brand should be ignored. The latter analysis could be very cumbersome for a development agreement intended to span multiple years, and could easily result in a finding that an exemption that was indisputably valid at the start of a relationship could later lapse, even in the absence of any change in the agreement between the parties, as the proportion of the franchisee's business related to the relationship expands.

- That the "total dollar volume in sales" of the franchisee includes all sales for all activities conducted by the franchisee, regardless of their source or location. For instance, if the franchisee is a grocery store operator with five stores, and the franchise agreement would place a franchised business within one of those stores, this calculation should take into account the franchisee's gross sales at all five stores for purposes of measuring the 20% threshold.

- The extent to which sales of the franchisee's parent, subsidiary, and affiliate entities should be included in the calculation of "the franchisee's total dollar volume in sales." In the FTC Franchise Rule Staff's Informal Staff Advisory Opinion 99-5, the FTC determined that "where a subsidiary licensee is wholly-owned, we will consider the income derived by the subsidiary licensee, *together with the income of its parent*, for purposes of applying the fractional franchise exemption. If the revenue of the wholly-owned subsidiary-licensee is less than 20% of the combined income of the parent and the subsidiary licensee in the first year of operation, then the subsidiary-licensee may qualify for the fractional franchise exemption." (emphasis added) The language in the proposed exemption does not appear to address this issue.

Under the experienced franchisor exemption, in section 2(a)(i)(2), the provision would require some kind of separate financial statements for a subsidiary whose parent prepares consolidated financial statements. However, when a corporate family reports through consolidated financial statements, the result may be that there are no formal financial statements (audited or unaudited) for the wholly-owned subsidiary. The model exemption does not indicate how the subsidiary franchisee should establish its shareholder equity where separate financial statements do not exist. When we have applied for this exemption in the past for Starbucks subsidiary SBC, which has not had separate audited financial statements, franchise examiners have granted the exemption notwithstanding the absence of separate financial statements for the franchisor subsidiary. We suggest that the exemption either should eliminate the separate $1 million equity requirement for the franchisor subsidiary entity, or should establish how the franchisor should document its equity when its financial statements are consolidated into its parent's. For instance, the franchisor could submit a certification from a corporate officer that its equity fairly exceeds the minimum threshold, based on a good-faith (but informal) evaluation of its assets and liabilities. The filing requirement for this exemption (under 2(b)(v)) suggests that this kind of certification would suffice, but by explicitly calling out "financial statements" in the underlying exemption provision, it is unclear whether a franchisor may rely on certification alone when formal financial statements do not exist.

Under the sophisticated franchisee/accredited investor exemption, it is unclear whether the equity of the franchisee's related entities may be consolidated in determining the $5 million equity threshold under 3(c)(i)(1)(c). Under the analogous federal exemption (16 C.F.R. § 436.8(a)(5)(ii)) and the corresponding compliance guide (at page 13), the parties "may aggregate commonly-owned franchisee assets in determining the availability of the large entity exemption." The proposed exemption does not specify whether multiple entities may be aggregated. It also does not establish whether a parent or affiliate of the franchisee may be relied on to establish the time-in-existence requirement, which also is permitted under the federal rule.

3. The "same type of business" standards

Several of the proposed exemptions employ a standard that measures the franchisee's general experience in related businesses or operational models. However, that standard is framed in several different ways, and it is unclear why the different exemptions do not use a common form. This concept appears in:

- Fractional franchise exemption (1(a)(i)): requires "more than 2 years of experience *in the same type of business*", which the exemption clarifies may be "in the same business selling competitive goods or services, or in a business that a consumer would reasonably expect to sell the type of goods or services to be distributed under the franchise."

- Existing franchisee exemption (3(a)(i)(2): requires that the franchisee or one of its officers, directors, managing agents or owners "has been engaged *in a business offering products or services substantially similar* to those to be offered by the franchise being sold."

- Sophisticated franchisee exemption (3(c)(i)(3)) and substantial investment exemption (3(d)(i)(3)): requires that the franchisee "has sufficient knowledge and experience *in the type of business operated under the franchise* . . . ."

Even without these variations, the "same type of business" standard is difficult to apply in practice, and does not lend itself to precise definition, because of the differences in relevant experience from one industry to the next. In light of that inherent challenge, we recommend at least eliminating the variations between exemptions and using a common form of phrasing to capture the experience requirement.

4. Miscellaneous

a. Fractional Franchise Exemption

In the fractional franchise exemption, section 1(d) directs the administrator to consider whether "both parties are capable of demonstrating" that the franchisee will derive 80% of its revenue from other sources. This could create a *de facto* burden of proof on the franchisor to establish the basis for the 80/20 calculus, since the risk of inaccurately applying an exemption falls entirely on the franchisor. Franchisors necessarily rely on financial disclosures from franchisees to determine whether the franchisee's other business activities will make up more than 80% of the franchisee's revenue, and a standard that would allow a hindsight determination that the franchisee did not have the financial sophistication to estimate its own revenues would place an unreasonable burden on the franchisor to vet the franchisee's finances. If the franchisee has made an independent representation to the franchisor about the franchisee's expected other revenues, then the franchisor should be permitted to rely on that representation. The federal standard does not include this "capable of demonstrating" standard, and it should not be introduced into state exemptions.

b. Experienced Franchisor Exemption

In the experienced franchisor exemption, we suggest an alternative to the "25 operating franchisees" standard under section 2(a)(ii). A franchise system may have been in existence for an extended period and may have hundreds of units in operation, but because of the success and growth of a handful of franchisees, it may not have 25 separate franchisees then in operation. SBC has found itself in this position in recent years. At one point in time, SBC had over 500 franchised units across the U.S., but just under 25 franchisees. By any conventional meaning of the term, SBC was an "experienced" franchisor, but would not have qualified for this exemption. We suggest an alternative formulation of the 2(a)(ii) standard, requiring either 25 franchisees, or a minimum number of franchised units combined with a smaller number of franchisees (for instance, 100 franchised units and 10 franchisees). This would accomplish the same policy end of ensuring genuine experience in franchising without unduly restricting the exact form of the franchise system.

Under 2(a)(iv)(1), it is unclear whether being "subject to any currently effective order of . . . the securities administrator of any state denying registration" would include a denial of a registration to offer franchises. The remainder of that section suggests that it is intended to

govern only individuals, but the introductory section (2(a)(iv)) suggests that it may also apply to "the franchisor" or other entities. It is not unusual for a state to deny registration when a franchisor has abandoned the application as the result of a substantial number of changes required by the state to the registration documents, or because of changes in the company's plans to franchise. That type of abandonment-*cum*-denial should not preclude a franchisor from qualifying for this exemption, and a simple clarification of this section would resolve that.

c. Sophisticated Franchisee (Accreditor Investor) Exemption

Under 3(c)(i)(1)(d), a trust may qualify as sophisticated by having "total assets" in excess of $5 million. It is unclear why a trust's value threshold is measured in "assets" while all other entities are measured in "equity." Since a trust generally may hold both assets and liabilities, consistency would suggest that the same standard be used for both.

Under 3(c)(i)(2), the prospective franchisee must be represented by legal counsel in the transaction. In effect, this requires the franchisor to require the franchisee to retain an attorney for the transaction, because the risk of not strictly complying with the exemption requirements falls entirely on the franchisor. In exempt transactions, a franchisee may not to use an attorney, typically because the exempt franchisee is a sophisticated, experienced organization with non-lawyers who routinely negotiate contracts without the direct assistance of counsel. Requiring that organization to use a lawyer only serves to increase the cost and complexity of the transaction for the both parties. The preferred construction would be that the franchisee has the *opportunity* to be represented by counsel, which would reserve the ultimate decision on legal representation to the franchisee.

Under 3(c)(ii)(2), the franchisee's financial statements must be prepared under U.S. generally accepted accounting principles. As with statements concerning the franchisee's revenue from unrelated business activities, the franchisor is rarely in a position to ascertain the franchisee's compliance with GAAP in preparing its financial statements. The franchisor should be entitled to rely on facially valid financial statements without having to assume the risk that those statements were not properly prepared by the franchisee or its accountants. At a minimum, the franchisor should be entitled to rely on a representation by the franchisee that the financial statements were prepared in accordance with GAAP.

d. Discretionary Exemption

The discretionary exemption is by necessity broad and general. However, we suggest a more specific standard for its application than that the registration and disclosure requirement "is not necessary or appropriate in the public interest or for the protection of prospective investors." This provides minimal guidance to a franchise examiner or securities administrator to determine which transactions should be exempted. In our experience, different franchise examiners applying this same standard have come to polar opposite conclusions, even when the underlying facts are essentially identical. We respectfully suggest alternative standards such as: the prospective franchisee is sufficiently experienced and capitalized to comprehend and mitigate its risks; the franchisor is sufficiently established to be accountable for any misrepresentations in the offer or sales process; the franchisor is sufficiently established that the nature of the franchised business is commonly understood and the franchisee can reasonably apprehend the risks and opportunities of operating a franchise; or the nature of the transaction presents a reasonably minor risk to the prospective franchisee in the context of its overall business operations and investments.

Again, we appreciate NASAA's efforts to promote uniformity in state franchise law, as well as the opportunity to provide these comments. If any of the discussion above is unclear or if there is any additional information we can provide, please do not hesitate to contact me at any time.

Sincerely,

David Byers
director, corporate counsel

cc: Joseph Opron (at jjo@nasaa.org)
Adam Ekberg, corporate counsel
Paul Mutty, vice president and assistant general counsel