

Excerpted and adapted from “ONLINE DISCLOSURE AND CONTRACTING,” a paper presented by **David W. Koch** (Wiley Rein & Fielding LLP) and **Deven Klein** (Kumon North America, Inc.) at the 2001 ABA Forum on Franchising. ©2001 American Bar Association.

ELECTRONIC OFFERING CIRCULARS? YES!

The Congressional drafters of the Electronic Signatures in Global and National Commerce Act (“E-SIGN”) envisioned that the new law would offer vast cost savings to businesses, by permitting them to shift paper-based activity into the electronic realm. Franchisors were quick to spot – but have been slow to seize – this potential. More than two years after E-SIGN, many franchisors remain leery of such radical notions as electronic delivery of UFOCs, perhaps waiting for some official blessing from the FTC and state franchise administrators. However, our Franchise Group has begun to receive regular inquiries from clients about the possibilities of electronic disclosure.

E-SIGN’s main function is to establish – on a national level – that electronic records and electronic signatures may not be denied effect solely because they are in electronic form, and that an electronic contract may not be denied effect solely because an electronic signature or record was used in its formation. Section 7001(a) provides:

Notwithstanding any statute, regulation, or other rule of law (other than this title and title II), with respect to any transaction in or affecting interstate or foreign commerce—

- (1) a signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form; and
- (2) a contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.

We believe that E-SIGN is all the “blessing” that franchisors really need to shift to electronic disclosure. This working paper explains why, but also touches on the impact of electronic signature laws on other routine dealings between franchisor and franchisee. Specifically, it assesses the status under E-SIGN of:

- ❖ providing franchise disclosure electronically
- ❖ filing franchise registrations in electronic form
- ❖ storing electronically the documents that state franchise laws require franchisors to retain

- ❖ entering into electronic franchise agreements, and
- ❖ transmitting statutory notices electronically.

A. Electronic franchise disclosure

Informal surveys indicate that relatively few franchisors are offering electronic delivery of UFOCs today (*e.g.*, by Internet download, as a email attachment, or on CD-ROM or diskette). By contrast, most franchisors do engage in marketing of their franchise concepts on the Internet. Because electronic UFOC delivery would be the next logical step to follow online marketing, it is instructive to start our analysis with the regulators' reaction to the marketing of franchise opportunities on franchisors' web sites.

1. *Electronic marketing of franchise opportunities*

When franchisors began to present information about their franchise concepts on their web sites, franchise attorneys struggled with two questions: (1) whether the information about the franchise opportunity on the franchisor's web site constituted an "offer" of a franchise, triggering state registration requirements, and (2) whether the online information was subject to the pre-publication filing requirement for advertising of franchise opportunities, applicable in nine states.¹ These pre-filing regulations were adopted with fixed media in mind, years before the widespread use of the Internet.

With respect to the first question, in 1998, the North American Securities Administrators Association ("NASAA") adopted a Statement of Policy Regarding Offers and Sales of Franchises on the Internet. NASAA took the view that posting information about the franchise opportunity should not subject franchisors to state registration requirements, as long as the franchisor included certain cautionary language and refrained from actual offers in a state prior to registration. Ten states have adopted NASAA's 1998 recommended exemption or a similar exemption as of August 15, 2001.²

With respect to the second question, some franchise attorneys argued that on-line franchise advertising was exempt from filing in California, Indiana, New York, North Dakota, Rhode Island and Washington under the exception for publications which have at least two-thirds of their circulation outside the state during the past year.³ If the "circulation" of the franchisor's web site is defined as all people worldwide (or even in America) who have access to the web

¹ The nine states are California, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, and Washington. The definition of "advertising" is broad. For example, as defined by Section 681 of the New York Franchises Act, Advertisement "includes any written or printed communication, or any communication by means of recorded telephone messages or spoken on radio, television, or similar communications media published in connection with an offer or sale of a franchise." Bus. Fran. Guide (CCH) ¶ 3320.02.

² The states are California, Connecticut (business opportunity law), Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, South Dakota, and Washington.

³ *E.g.*, *Franchise Law Compliance Manual* 122 (Steven M. Goldman & H. Bret Lowell eds., 2000).

site, then the advertisement will always meet the two-thirds rule. Application of the two-thirds circulation rule to an electronic advertisement, however, is not an exact comparison to its fixed medium counterpart: two-thirds of the latter is tallied by the medium's circulation containing the advertisement outside the state; the former is counted by the advertisement itself, which has a unique URL. Furthermore, an electronic advertisement's "circulation" can never be known prior to its publication because the number of "hits" to the URL is the only true indicator of visits to the site.

The uncertainty about Internet advertising was not limited to franchise attorneys. Some franchise regulators were also unsure if they had authority to disapprove Internet advertising in their respective states. In an attempt to clarify the Internet advertising issue, NASAA's Franchise and Business Opportunity Project Group ("Franchise Project Group") published a Proposed Statement of Policy Regarding Franchise Advertising on the Internet on July 11, 2001.⁴

The Franchise Project Group recommended exemption from state advertising filing requirements with respect to passive forms of Internet communication about a franchise offering. The proposed conditions to the exemption are straightforward: (1) franchisors must include the URL of any franchise advertising on the offering circular cover page with applications for registrations and exemptions; and (2) the advertisement cannot be directed at specific persons.⁵ Notice to state franchise administrators should be filed if a new URL of a franchise advertisement is created. The proposal also implies that notice of URL franchise advertising should be required for renewal exemptions in Indiana and the top-tier exemption in New York where no application is required.⁶

Of course, states would be free to adopt, reject, or modify NASAA's Internet advertising policy. But the Proposed Statement of Policy Regarding Franchise Advertising, like its predecessor on online offers and sales, demonstrates at least some desire to accommodate electronic commerce in franchise systems.

At the federal level, the Federal Trade Commission Act does not specifically address Internet advertising, but the general prohibition against "unfair or deceptive acts or practices" extends to Internet advertising.⁷ Thus, although the FTC's Franchise Rule⁸ does not explicitly cover online franchise advertising, its prohibition against advertising information that is inconsistent with an offering circular clearly applies in cyberspace. The FTC has instituted over 100 law enforcement

⁴ The policy is available in PDF format on NASAA's website: <http://www.nasaa.org/nasaa/abtnasaa/display>.

⁵ *Id.*

⁶ Bus. Fran. Guide (CCH) ¶ 3320.05 (New York); Bus. Fran Guide (CCH) ¶ 3140.03 (Indiana).

⁷ See Federal Trade Commission, *Dot Com Disclosure: Information About Online Advertising* (FTC staff paper May 3, 2000). The paper is reproduced at <http://www.ftc.gov/bcp/online/pubs/buspubs/dotcom/index.html>.

⁸ 16 C.F.R. § 436.1(f).

actions dealing with advertising, marketing, and sales online since 1994, but none concerning online franchise advertisements.⁹

A May 3, 2000 FTC staff paper, *Dot Com Disclosure: Information About Online Advertising*, specifies that online advertisements must be truthful and not misleading, advertisers must have evidence to back up their claims, and the advertisements cannot be unfair.¹⁰ The staff paper, which serves as a compliance manual for online advertisers, also provides recommendations for providing clear and conspicuous statements particular to Internet advertising. These suggestions include close proximity between a claim and a disclosure tied to it, scrollable text, clear and consistent labeling of hyperlinks, and in the case where a disclosure is hyperlinked, it should be contained on one page no longer than one click away.¹¹

Another FTC business education publication, *Advertising and Marketing on the Internet: Rules of the Road*, provides links to FTC laws about specific marketing practices and the promotion of products and services in specific industries, including the Franchise Rule.¹² Readers of the guide are therefore on notice both that: (1) the online advertisement is subject to the FTC's general advertising standards; and (2) the advertiser's industry is subject to specific FTC regulation.

2. *FTC Rule proposal for electronic disclosure*

As noted above, from electronic marketing of the franchise opportunity, the next logical step is electronic delivery of the Uniform Franchise Offering Circular. The FTC staff addressed this issue first in an informal staff advisory opinion, in the context of delivering a UFOC on diskette or CD-ROM.¹³

The staff opinion letter was a response to a question (submitted in December 1996) about whether a franchisor may satisfy the Franchise Rule by delivering a disclosure document via computer diskette. The opinion letter answered "yes," provided that: delivery by computer diskette was at the option of the prospective franchisee; the franchisor disclosed the word processing format used; and the diskette had clear labeling regarding its contents and ordering.¹⁴ In its subsequent Internet Notice, published May 6, 1998, the Commission sought comment on the applicability generally to electronic media of the FTC rules and guides.¹⁵ The Internet

⁹ *Dot Com Disclosure*, *supra* n. 59, at 3.

¹⁰ *Id.* at 4.

¹¹ *Id.* at 5-9.

¹² Federal Trade Commission, *Advertising and Marketing on the Internet: Rules of the Road* (September 2000). The publication is reproduced at <http://www.ftc.gov/bcp/conline/pubs/buspubs/ruleroad>.

¹³ FTC staff advisory opinion 97-2, Bus. Fran. Guide (CCH) ¶ 6482 (December 3, 1996).

¹⁴ Bus. Fran. Guide (CCH) ¶ 6482.

¹⁵ 63 Fed. Reg. 24996 (May 6, 1998).

Notice's concerns regarding consent, confirmation, delivery, and potential manipulation of electronic information heavily foreshadowed action in the Franchise Rule area.

On October 22, 1999 – before E-SIGN was enacted, but in the midst of the Congressional debate – the FTC published a Notice of Proposed Rulemaking (NPR) concerning the Franchise Rule.¹⁶ The NPR includes a proposal concerning electronic disclosures. The NPR proposals, while generally advocating electronic disclosure, attach many restrictions. The NPR would require: (1) informed consent by a prospective franchisee before receiving an electronic UFOC; (2) simultaneous delivery of a paper summary; (3) preservation, presentation, and accessibility of electronic documents; and (4) retention of archival copies. The Commission commented in the NPR that “until such time as electronic media are more widely used, and consumers are more comfortable with such media, the traditional paper copy should remain available as an option.”¹⁷

For a variety of reasons, the Franchise Rule proceeding has moved very slowly. However, in July 2000, the FTC invited franchisors to propose electronic disclosure demonstration projects consistent with the conditions of the NPR.¹⁸ A few proposals were received from franchise industry vendors such as FRANDATA, Inc., ETRANA, Inc. and Franchise.com, and some vendors now offer electronic disclosure services according to the NPR. As discussed below, however, we think it is unnecessary to follow the unwieldy NPR procedures.

3. *Electronic disclosure under E-SIGN*

E-SIGN does not require any person to agree to use or accept electronic records or electronic signatures, *other than a government agency with respect to a record other than a contract to which it is a party*.¹⁹ The negative implication of this provision is that E-SIGN *does* require a government agency to “agree to use or accept” electronic records except when the agency is a contracting party (in which case it has the same option as private parties). Thus, if the offer and sale of a franchise is within the scope of E-SIGN (which it is, as discussed below), we believe

¹⁶ 64 Fed. Reg. 57316 (October 22, 1999) (hereafter “NPR”).

¹⁷ While the Franchise Rule proceeding has been dormant, the FTC has been active in providing further general guidance on using the Internet. Internet advertising guides have supplanted the Internet Notice, to which the NPR expressly refers. For example, proposed section 436.7(d) of the NPR calls for a single, self-contained electronic document, which the NPR likens to the Internet Notice's recommendation:

On the Internet or other electronic media, this means that consumers viewing an advertisement should necessarily be exposed to the disclosure in the course of a communication without having to take affirmative action, such as scrolling down a page, clicking on a link to other pages, activating a ‘pop-up,’ or entering a search term to view the disclosure.

But now the FTC offers very different advice. A May 3, 2000 staff paper directs advertisers to avoid web page formats that discourage scrolling, and it permits hyperlinked disclosures except in the case where disclosures are an integral part of a claim or inseparable from it.

¹⁸ 65 Fed. Reg. 44484 (July 18, 2000).

¹⁹ Section 7001(b)(2).

that E-SIGN supersedes the NPR and compels the FTC (and state franchise administrators) to “accept” electronic delivery of the UFOC between private parties as satisfying the requirement of “written” disclosure.

E-SIGN applies to any “transaction,” as defined in the statute. Delivery of a franchise offering circular seems to be well within that definition, as it constitutes “an action . . . relating to the conduct of business, consumer, or commercial affairs between two or more persons.” The offer and sale of a franchise is clearly a “business” or “commercial” affair, and in any case the E-SIGN definition of “transaction” specifically includes the licensing of intangibles. And there seems little question that the Uniform Franchise Offering Circular is a “record relating to such transaction” under Section 7001(a)(1) of E-SIGN.²⁰

However, E-SIGN contains special “informed consent” requirements for *consumer* disclosures, which raises the question whether prospective franchisees are to be viewed as “consumers.” Judging from the NPR, the FTC assumes that prospective franchisees are “consumers,” but we believe that view conflicts with E-SIGN. In E-SIGN, the term “consumer” means *an individual who obtains, through a transaction, products or services which are used primarily for personal, family, or household purposes*. Because a prospective franchisee acquires a franchise for business or commercial purposes, not for personal, family, or household purposes, a prospective franchisee is not a “consumer” under E-SIGN, and the informed consent provisions therefore don’t apply.

We believe that E-SIGN authorizes franchisors to deliver offering circulars in electronic form without waiting for the FTC to act on the NPR (assuming, of course, that the prospective franchisee agrees to electronic delivery).²¹ Franchisors may therefore deliver their UFOCs by CD-ROM, email, or Internet download without undue concern that the disclosure will later be viewed as somehow tainted or inadequate. We do recommend, however, that franchisors obtain verification of the prospective franchisee’s desire to receive the UFOC in electronic form and his or her ability to view the entire UFOC in the form delivered. This verification could also be furnished by email or in other electronic form.

The FTC staff has acknowledged that the NPR proposals for electronic disclosure will be revised in light of E-SIGN.²² Moreover, the FTC staff has advised franchisors individually that, under E-SIGN, the FTC cannot prohibit them from using electronic delivery methods.²³

²⁰ Although there may be a contrary argument that delivery of an offering circular is excluded from E-SIGN as a “governmental affair,” which the drafters chose not to cover, that argument seems weak. The proper focus is on a commercial transaction — the offer and sale of a franchise. Delivery of an offering circular has no independent significance apart from such a transaction — delivery is not required by law, and would not occur, if no transaction is contemplated.

²¹ However, E-SIGN has no effect on either the required *timing* of UFOC delivery or the substantive content of the disclosure.

²² Telephone interview with Steven Toporoff, *supra* n. 91.

²³ *Id.*

Should the FTC nevertheless choose to proceed with the electronic disclosure proposals in the NPR, E-SIGN will tightly circumscribe the conditions under which the FTC can go forward. Although the FTC retains authority to interpret the requirements of E-SIGN in connection with its rulemaking activities, the exercise of that authority is subject to strict limitations. The Commission could not, for example, define a prospective franchisee to be a “consumer” under E-SIGN, because that interpretation would conflict with E-SIGN. It also seems unlikely that the NPR’s electronic disclosure proposals would survive scrutiny under E-SIGN, because the proposals would do more than merely “interpret” E-SIGN. Even if they could be viewed as mere interpretation, the proposals might be invalidated on the grounds that they “add to the requirements” of E-SIGN or that the FTC did not make the specific findings required by the statute.

The FTC might argue that its proposals are similar to the informed consent requirements of E-SIGN and therefore do not “add to” the obligations under Section 7001 (of which the informed consent provisions are a part).²⁴ But that argument should fail on the basis that prospective franchisees are not consumers to whom E-SIGN’s informed consent provisions apply. Because E-SIGN’s informed consent provisions would not apply to them, the FTC would, in fact, be adding to the requirements of Section 7001 by requiring special procedures for prospective franchisees.²⁵

B. Electronic Filing of Franchise Registrations

E-SIGN does not compel state franchise administrators to accept franchise filings in electronic form under the states’ existing laws and regulations. Section 7004(a) of E-SIGN preserves state authority to require that records be filed with an agency in accordance with specified standards or formats, and the legislative history confirms that this may include paper filing requirements. However, it is possible that individual states may have adopted laws similar to the Government Paperwork Elimination Act, which will generally require federal agencies to accept electronic filings by October 2003.

On the other hand, if a state franchise administrator adopts *new* filing requirements, there is at least an argument that the preservation of authority in Section 7004(a) does not apply. If that argument is correct, the franchise administrator presumably would be subject to the limitations on interpretive authority under Section 7004(b) of E-SIGN.²⁶

²⁴ For example, the NPR, like E-SIGN, would require express consent, an opportunity to withdraw consent, and prior notice of hardware and software specifications.

²⁵ The FTC does not seem inclined to re-impose a requirement that an offering circular be in a tangible printed or paper form, but if it were, Section 7004(c)(1) of E-SIGN would apply, and would require the FTC to have a “compelling governmental interest” relating to its law enforcement mission and to show that the paper requirement is “essential” to that interest.

²⁶ NASAA is reportedly at work on the electronic filing issue. See the materials for Workshop 1 of this ABA Forum for further information.

C. Records Retention

State franchise statutes impose various record retention requirements on franchisors. For example, Minnesota, North Dakota, and South Dakota require that a franchisor retain offering circular receipts for a period of three years.²⁷ New York requires franchisors to maintain a complete set of books and records, as well as accounts of franchise sales.²⁸

E-SIGN guarantees that electronic records kept by the franchisor satisfy these requirements, as long as the records accurately reflect the information set forth in the UFOC receipt or franchise agreement (or whatever other document the state requires be kept), and as long as the electronic records remain accessible “to all persons who are entitled to access by statute, regulation, or rule of law” (which, at a minimum, would include the state franchise administrator, and presumably the franchisee whose record is involved). Under Section 7004(c)(1) of E-SIGN, requiring the private sector to retain *paper* records is prohibited unless the state franchise administrator can establish that the requirement is “essential” to a compelling governmental interest relating to law enforcement.” State administrators could, however, prescribe “performance standards” for record retention under Section 7004(b)(3)(A) of E-SIGN to assure accuracy, record integrity, and accessibility. The statute specifies that this authority does not permit the agency to “require use of a particular type of software or hardware.”²⁹

The FTC Franchise Rule does not currently contain express record retention requirements. However, proposed section 436.7(f) of the NPR would require retention of archival copies of offering circulars. Whether the NPR would require *paper* retention is ambiguous. On the one hand, the FTC states that “franchisors must maintain a specimen copy...” without specifically mentioning “paper.”³⁰ Yet the NPR expresses agreement with a commenter who believes that record keeping would be difficult if available only in electronic form.³¹ A paper retention requirement would, as noted above, be subject to Section 7004(c)(1) of E-SIGN.

D. Electronic Contracting

Under E-SIGN, a franchise agreement may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation. Moreover, an electronic version of the contract satisfies any requirement of state law that the franchise agreement be in writing, unless the electronic version is not capable of being retained and accurately reproduced by all parties.

²⁷ Franchise Law Compliance Manual, *supra* n. 55, at 157.

²⁸ Bus. Fran. Guide (CCH) ¶ 3320.04.

²⁹ This is perhaps best read to mean that the state agency cannot specify software or hardware by brand; it presumably does not prohibit a requirement to use software or hardware that conforms to particular technical specifications.

³⁰ NPR proposed Section 436.7(g).

³¹ *Id.*

The only real statutory impediment to a franchisor switching to electronic agreements is that E-SIGN does not compel the franchisee to agree to use them. However, if the franchisor can convince franchisees to execute the contract in electronic form, franchise relationships may be formed without the use of a single sheet of paper.

E-SIGN does not require franchisors to use electronic signature methods that guarantee to each party the identity of the other. Such security measures may, of course, be a requirement for commercial acceptability — and for an international contract, they may be required in order to obtain full legal recognition of the agreement in one party's country.

E. Electronic Notices

State franchise relationship statutes often require a franchisor to provide “written” notice before taking a variety of adverse actions against a franchisee. A termination or nonrenewal notice in California, for example, must be in writing and posted by registered, certified or other receipted mail, delivered by telegram or personally delivered to the franchisee.³² May franchisors send electronic notices even though some state statutes call for precise delivery and receipt methods?

Under E-SIGN, a default notice is (like a franchise offering circular) a “record” relating to the franchise transaction between franchisor and franchisee. Accordingly, if the parties have agreed in the franchise agreement to use electronic means for notices, E-SIGN would say that the notice cannot be denied effect under the state relationship law merely because it is in electronic form.

On the other hand, E-SIGN's effect is limited to satisfaction of the statutory requirement of a writing. It does not override other requirements of state law — such as, in the California example, the requirement of a specific delivery method.³³ Thus, in an odd twist, an electronic notice might satisfy a statute like the California Franchise Relationship Law only if it were mailed on a diskette to the franchisee. If, however, the statute does not specify a delivery method, an email or other electronic transmission that conforms to the contract would appear to be effective.

³² Bus. Fran. Guide (CCH) ¶ 4050.17.

³³ See 146 Cong. Rec. S5222 (daily ed. June 15, 2000) (statement of Sen. Leahy). However, note that the state may have enacted the UETA, and the UETA contains a delivery provision (Section 8).