Client Alert

ARMSTRONG TEASDALE LLP

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ANTITRUST, FRANCHISE AND DISTRIBUTION PRACTICE GROUP

FTC ISSUES REVISED FRANCHISE RULE

On January 23, 2007, the Federal Trade Commission announced the approval of long-awaited amendments to the Franchise Rule, which was originally promulgated by the FTC in 1978. Although franchisors are permitted to begin complying with the amended rule on a voluntary basis as of July 1, 2007, compliance becomes mandatory on July 1, 2008. The amended rule only applies to the sale of franchises to be located in the United States and its territories, and provides several significant exemptions for sophisticated franchise purchasers.

The amended rule is intended to further the FTC's stated goal of preventing "deceptive and unfair" practices in the franchisor-franchisee context, and to address concerns raised by some franchisees that the original rule did not go far enough to protect their interests. The resulting rule both expands a franchisor's disclosure obligations, while at the same time eases some of the compliance costs created by the original rule. Through the amended rule the FTC has also narrowed the differences between federal and state pre-sale disclosure requirements. The FTC Franchise Rule will now closely parallel the UFOC Guidelines promulgated by the North American Securities Administrators Association ("NASAA"). NASAA represents the 15 states that have implemented pre-sale franchise disclosure and/or registration regulations.

The amended rule requires franchisors to make expanded disclosures relating to, among other things:

- Franchisor-initiated litigation;
- A franchisor's use of "confidentiality clauses" in lawsuit settlements;
- Warnings that must be provided when a franchisee does not have an exclusive territory; and
- The bankruptcy history of any of the franchisor's predecessors and affiliates.

The amended rule will also affect how franchisors make financial representations in their disclosure documents. Although the amended rule does not require a franchisor to make financial representations, as had been requested by some franchisee advocates, a franchisor is required to include a preamble that specifically advises franchisees that the franchisor is not precluded from doing so. Franchisors who choose not to make financial representations are also required to provide a second preamble which advises franchisees not to rely on unauthorized performance representations. If made, financial representations must be included as part of the disclosure document itself. The amended rule also eliminates the original rule's requirement that franchisors use GAAP principles when preparing historical financial performance data.

In some areas the requirements of the amended rule are narrower than the NASAA's UFOC Guidelines, and simplify the manner in which disclosures to franchisees must be made. The amended rule enables a franchisor to comply with pre-sale disclosure obligations electronically, and also dispenses with the original rule's "first personal meeting" disclosure trigger. Under the amended rule a franchisor is required to deliver its UFOC to prospective franchisees at least 14 calendar days before the prospective franchisee signs a binding agreement with the franchisor or makes any payment to the franchisor. Under the existing version of the rule, a franchisor is compelled to provide prospective franchisees with a copy of the UFOC at the earlier of the first personal meeting or ten days prior to the execution of any franchise contract or the payment of any fees in connection with the franchise sale.

Finally, the amended rule preserves the text of the original rule as it pertains to "business opportunity" ventures, which include such things as vending machine routes and rack display operations. Requirements relating to business opportunity ventures, which differ from franchises in that they do not generally include the right to use trademarks or other commercial symbols, will now be covered in a separate rule, which has been identified by the FTC as the Business Opportunity Rule. The FTC is currently conducting proceedings to consider possible amendments to the Business Opportunity Rule.

Although mandatory compliance with the amended rule's many changes is more than 16 months away, franchisors are well served to begin the process of reviewing and revising their disclosure documents and franchise solicitation materials and procedures in order to ensure future compliance with the amended rule.

SUPREME COURT REVERSES $79 MILLION AWARD IN CLOSELY WATCHED PREDATORY-BIDDING SUIT

On February 20, 2007, the U.S. Supreme Court released its unanimous decision in the much anticipated antitrust case of *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*, ruling that the test the Court had applied to predatory-pricing claims in *Brooke Group Ltd. v. Brown and Williamson Tobacco Corp.* also applies to predatory-bidding claims.

The case involved claims of predatory-bidding in the lumber industry. Predator-bidding, as distinguished from predatory-pricing, is a practice that occurs on the buy side of the market. Predatory-bidding involves a buyer exercising market power to bid up input prices in the short-term in an effort to drive competing buyers out of the market, and then later, after acquiring the requisite monopsony power, driving down input prices in the long-term so that the predatory buyer may enjoy supracompetitive profits that more than offset its previously-sustained short-term losses. In this case, Ross-Simmons alleged that Weyerhaeuser, a competing sawmill, had artificially increased prices in the sawlog market by: (1) paying higher prices than necessary ("predatory-bidding") and (2) buying more than necessary ("predatory-overbuying").

Ross-Simmons filed suit in district court, claiming Weyerhaeuser's conduct violated Section 2 of the Sherman Act. When it came time to submit jury instructions, the district court rejected the application of the objective *Brooke Group* standard to Weyerhaeuser's conduct in favor of a much more subjective standard:

> *One of Ross-Simmons contentions in the case is that Weyerhauser purchased more logs than it needed or paid a higher price for logs than necessary, in order to prevent Ross-Simmons from obtaining the logs Ross-Simmons needed at a fair price. If you find this to be true, you may regard [the conduct] as an anticompetitive act.*

The jury found for Ross-Simmons and, under the Sherman Act's treble damages provisions, the district court awarded Ross-Simmons $79 million in damages. Weyerhaeuser appealed to the Ninth Circuit, claiming its alleged conduct was not actionable under Section 2 of the Sherman Act if the appropriate *Brooke Group* standard was applied. The Ninth Circuit also rejected Weyerhaeuser's application of the objective predatory-pricing standard to predatory-bidding claims.

However, the U.S. Supreme Court overturned the $79 million verdict in favor of Ross-Simmons, unanimously endorsing the application of the two *Brooke Group* prerequisites to recovery on a predatory-pricing claim to predatory-bidding claims:

- a plaintiff must show that the prices in question are below cost; and
- a plaintiff must show that the defendant had "a dangerous probability of recouping its investment in below cost pricing."

The Court, calling predatory-bidding and predatory-pricing claims "analytically similar" and identifying "the close theoretical connection between monopoly and monopsony," noted that both practices involve the intentional use of unilateral below-cost pricing measures for anticompetitive purposes and sustaining short-term losses in hopes of eventually reaping long-term profits, before concluding that the same objective standard should apply.

The Court also highlighted the consequences that the application of a more subjective standard, like the one applied at the trial level, may have on the marketplace, noting a concern for the "chilling" impact that such a standard would have on procompetitive conduct. The application of the *Brooke Group* standard, the Court concluded, through the second prerequisite, distinguishes between anticompetitive and procompetitive conduct, and thereby benefits the ultimate consumers. In fact, the Court suggested that predatory-bidding conduct likely presented less of a direct threat to consumer harm than predatory-pricing conduct.

Though the Court's holding is a rather narrow one, the case does serve to consolidate the law of predatory-pricing and the law of predatory-bidding under a common objective standard, and provides aggressive buyers with a more clearly-defined defense based upon "a close analysis of both the [buyer's conduct] and the [relevant market's] structure and conditions."

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