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Regulating Franchise Relationships: Empirical Efficacy and Recommendations for Reform

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I. WHAT IS FRANCHISING?

A. INTRODUCTION

Flipping through a copy of *Entrepreneur's* magazine, one finds a plethora of franchising opportunities advertised. From hotels to restaurants to home cleaning services, franchised businesses play a substantial role in America's economy. The early franchisors were gas station dealers, soft drink bottlers, and automobile manufacturers, who relied on the franchise business model to more efficiently distribute their goods. Since the 1950s, though, franchising expanded rapidly. Major players are familiar to most Americans: Dunkin' Donuts, Starbucks, McDonald's, Holiday Inn, Kentucky Fried Chicken, and 7-Eleven, among others. It is estimated that between forty and eighty percent of all the US's retail sales is done through franchised business outlets. (Burke & Abel, 2003) Franchised businesses account for $2.31 trillion dollars of annual output, or 11.4 percent of all private sector output in the United States. And, from 2004 to 2005, average annualized growth in output attributable to franchises was 10.9%. In 2001, the International Franchise Association reported that, in the U.S when both direct and indirect forms of employment were combined, franchising generated one out of every seven jobs in the private sector. Despite the prevalence and successful expansion of franchising as a business format in the US, franchising is not without risks. A recent study by the American Franchise Association suggests that achieving success with a franchised outlet requires a long-term timeframe. The study found that the majority of franchisees surveyed (72.6%) with more than thirty-two months of experience reported themselves financially successful. However, only 57.5% of franchisees with less than thirty-two months of experience felt the same about their financial success. Further, the risk of failure is significant. The Office of Advocacy of

the U.S. Small Business Administration found that, between 1986 and 1991, 38.1% of start-up franchised businesses had shut down, compared with 31.9% of independent business start-ups. Further, a mere 76% of franchisor parent companies that existed in 1983 were still in business as of 1993.

The difference in failure rates of six percent does not seem especially significant, but when put in the context of the heavy capitalization and information and knowledge advantage afforded to a start-up franchised business, it points to the existence of substantial risks in the franchise business relationship. Typically, regulators and those in the industry categorize franchising problems into two categories: relationship problems and disclosure or inducement problems. (Burke & Abel, 2003) Relationship problems refer to those that arise after the franchise has begun operation. Disclosure or inducement problems refer to issues that arise or are predicated in lacking disclosure, material omissions, and misrepresentations of information prior to the initiation of the franchise agreement. Many times, franchisees claim they would not have signed the contract had it not been for the information discrepancy. With the existence of issues specific to franchising and a unique type of business contract, the question of franchise regulation comes into play. How should franchises be regulated? In what ways can general contract or common law protect the interests of the franchisee and franchisor? These questions have been hotly contested in recent years, as lawmakers, industry advocates, franchisors and franchisees vie to safeguard their own economic interests in advocating or opposing potential reforms to franchise law in America.

As such a prevalent facet of the economy, it is imperative that the relationships between franchisee and franchisor are properly governed and regulated to mitigate the risks to both parties and reduce litigation and the potential for conflict, all the while ensuring that those regulations don't impede the long-term sustainability and profitability of the franchising industry by reducing efficiency, misaligning incentives, or too tightly restricting the market. This has proven to be an enormous and hotly contested challenge, and many critics regard the current regulatory environment as disparate and incomprehensive.

The most stringent and comprehensive franchise relationship laws exist in Iowa, under the Iowa Franchise Act passed in 1992. Iowa's franchise regulation overhaul met harsh criticism and opposition from the business community and lobbyists representing franchisor trade groups. Following passage of the law in 1992, McDonald's and Holiday Inn refused to grant new franchises in Iowa until the act was repealed. (Hess, 1995) And, despite demonstrated interest in passing similar comprehensive franchise relationship reform laws in various other state legislatures, franchisors have been largely successful in stymieing passage of any new laws. The efforts to curb passage of more regulation in the franchise industry go even further. The International Franchise Association (IFA), an industry group for franchisors, adopted a Code of Ethics, which is to provide standards of conduct for franchisors. This Code of Code of Ethics is purported to eliminate the need for further regulation in the industry. However, these attempts at self-regulation by the franchisors are largely seen as inadequate as a meaningful mechanism for enforcing franchisee rights.

The goal of this paper is to examine the current regulatory framework surrounding franchise agreements and its efficacy in mitigating risks and promoting sustainable profitability and efficiency. It is clear from a cursory survey of the industry landscape that the current state of franchise regulations is disparate and incomprehensive. Further, it seems that the implicit dependency of a franchisee on a franchisor in the business relationship exposes the franchise industry to complexities and risks that go beyond that of simply operating a small business in the marketplace. This paper seeks to identify the inherent risks in a franchise relationship for both the franchisee and franchisor. It will look at why contracts are typically one-sided in favor of the franchisor, how franchise contracts are functioning in the current legal environment, and what regulatory measures are required to bolster the health of the industry, protect the interests of both parties, and reduce reliance on litigation and arbitration.

B. CATEGORIES OF FRANCHISE RELATIONSHIPS

David Kaufman defines franchising as a system of marketing and distribution in which an independent entity (the franchisee) is granted the right to market the goods or services of another entity (the franchisor) in accordance with the established standards and practices of the franchisor, typically with the franchisor taking on a continuous advisor role in the business relationship. The franchisee pays for these rights and knowhow through an assortment of fees, such as start-up fees, ongoing royalties, rent, and percentages of the business's profit. The franchisee will also sometimes indirectly remunerate the franchisor through use of the franchisor as a supplier for the goods and services.

There are two primary categories of franchising: product and trade name franchising, and business format franchising. (Kaufmann, Understanding Franchising, 2001) Under the former, a franchisee sells a company's product line, and partially subsumes the identity of that company as the market conduit for the sale of that company's products. A common franchise relationship that falls under this category would be car dealerships or gas stations.

Business format franchising, a more involved relationship than the former category, is prevalent in the US economy. McDonald's falls into this category. From the consumer's perspective, eating in a franchised McDonald's in Texas owned by "A" should be indiscernible from eating in a franchised McDonald's in Alaska owned by "B." McDonald's disseminates operational guidelines, as well as standards for the appearance of the restaurant, the menu, signage and ingredients, and the cooking and preparation appliances. McDonalds Corporation also exerts control over many other aspects of the business in order to standardize its franchised restaurants. This type of franchise agreement is commonly referred to as business format franchising, in which each franchise location, although independently owned, conforms to standard business practices and operations dictated by the franchisor. This type of franchising has been gaining popularity, and constitutes a significant percentage of franchise business growth over the last 60 years. Many highly visible businesses fall into the business format category, including restaurants, convenience stores, hotels, auto repair centers, retailers, and various personal and business services chains. (Kaufmann, Understanding Franchising, 2001)

C. MUTUAL BENEFITS: INCENTIVES BEHIND FRANCHISING

1. Benefits for Franchisees

The franchisee enjoys numerous benefits. When franchising with a well-known company, the franchisee gains name recognition that would be enormously expensive or even impossible to obtain independently. The franchisee is afforded operational knowhow, training, supervision, suppliers, advertising, and collective buying power. (Kaufmann, Understanding Franchising, 2001) They are also given a degree of certainty and proven profitability that independent small business operators do not enjoy. In most cases, a franchisee can look to copious empirical evidence of other franchisees operating in numerous locations as proof of the workability and profit potential of the business. The contrast in failure rates between independent small businesses and franchised outlets is illustrative of the competitive advantage afforded to franchisees. 65% of new businesses fail within five years, whereas only 14% of franchised operations were shut down or under different ownership within the same timeframe. In fact, only 3% of new franchises entirely failed within five years. (Kaufmann, Understanding Franchising, 2001) An indicator of widespread success amongst franchisees is that 92% of owners reported their franchises to be either somewhat or very successful, according to a Gallup Organization study conducted in 1997.

2. Benefits for Franchisors

Typically, if a corporation wants to open new locations or outlets, they must expend a significant amount of capital. Under franchising, however, a business can enjoy expansion with capital *infusion*. Of course, they are relinquishing the rights to the full

profits enjoyed by the franchisee's outlet, but via start-up franchise fees and on-going royalties based on a percentage of profit, the company can profit significantly from opening franchised outlets. In addition, it would be reasonable to assume that an independent owner would be more vested in maximizing the profitability of an outlet as compared to a salaried manager at a corporately owned store. This is not to suggest that franchised outlets enjoy consistently greater returns than corporate stores. However, sales growth and profitability, alongside softer measures of performance such as customer satisfaction, and efficiency may be enhanced by the vested stake a franchisee has in the success of her/his business as compared to a salaried manager.

D. MECHANISMS OF THE FRANCHISE CONTRACT

The franchise contract, sometimes referred to as the franchise agreement, is the formalization of the relationship between the franchisee and franchisor. This encompasses the initial arrangements and start-up procedures, as well as the ongoing relationship between the franchisee and franchisor. David Kaufman provides an exhaustive list of obligations subsumed by both parties, which is illustrative in grasping the scope of the relationship controlled by the contract. This is not the full list, but highlights areas of particular importance when considering the relationship:

Franchisor

- Grants franchisee the right to operate a franchised unit
- Right to use a franchisor's knowledge of running the business

- Furnishes to franchisee information, operational guidelines, and instructions, which encompass a proven model for operation of the business
- Licensing use of the franchisor's trademarks and logos
- Territorial exclusivity (no other franchisee or the franchisor can set up another branch of the franchise within a certain jurisdiction)
- Granting the franchise for a specified period of time, with the option of renewal
- Supplying goods/services to the franchisee, such as burger patties at McDonald's or a national advertising campaign
- Dictates where the franchisee can locate the franchise
- May control the right of the franchisee to transfer ownership or sell the franchise

Franchisee

- Payment of an initial franchise fee, simply to obtain the rights to operate the franchise
- Payment of ongoing royalties for assistance from the franchisor and the continuing right to operate under the franchise name
- Agreement to consistently comply with the procedures and standards of the franchisor
- Use of franchisor's name, logo, and trademarks
- Exclusivity in selling or providing only the goods/services explicitly related to the franchise, and not selling any other product or service
- Promise to expend a certain amount on local advertising
- Payments to build-out franchise location to franchisor's specifications

- Supervise franchise location and conduct hiring practices as dictated by the franchisor
- Adhere to a standardized method of accounting as dictated by the franchisor
- Mandatory payment into a national advertising fund, in addition to royalties, rent, and start-up fees
- Indemnification of franchisor for liability arising solely from acts committed by franchisee
- Consent to retraining and on-site inspections
- Loss of right of competition with the franchise business for a period of time following termination of the franchise agreement (For instance, a McDonald's franchisee, following termination, may be disallowed from opening a Burger King or other competing restaurant for a specified period of time)

This is certainly not an exhaustive list of obligations and rights covered by a franchise agreement, but it does provide a glimpse of the breadth and complexity implicit to governing this sort of business relationship. Next, we will examine the specific interests that are uniformly addressed in a franchise contract.

II. FRANCHISE CONTRACTS

The contract that a franchisor uses with individual franchisees is typically standardized, wherein there is little change in terms across a company's franchises. A standard contract is drawn up by the franchisor to govern the initiation of the business relationship and the ongoing terms. Since a contract is drawn up by the franchisor, it

explicitly addresses issues and obligations that are of interest to the franchisor. For example, franchise contracts typically grant the franchisor a large amount of flexibility in terminating a relationship with a franchisee. A company does not want the poor performance or lacking compliance of a franchisee to harm the image of the parent company, whose name the franchisee's business bears. Thus, it is important to a franchisor to grant themselves the legal right to early termination of a relationship. The contract will specify the conditions for termination, including: failure to meet set sales volume, failure to meet specific operating standards and procedures, and other failures to comply with obligations under the agreement. (Hess, 1995) It is in the interest of the franchisor when writing up the contract to include a greater number of conditions for termination, in order to afford themselves more flexibility in terminating the relationship later. For the franchisee, this means the prospect of essentially at-will termination of the business relationship at any time. Other rights that the franchisor may grant themselves in the contract are: refusal to renew a franchise agreement, franchisor approval before transfer of ownership or sale of the franchise, or requirements that the franchisee not operate a competing business after termination or nonrenewal. (Hess, 1995) This sort of misalignment of interests permeates a franchise agreement. As a result, contracts are generally franchisor-friendly and may not provide explicit and needed protections to franchisees. However, in order to fully address this, we must first address what protections and corresponding terms in a franchise contract are needed to address the risks to which a franchisee is exposed.

Why is there such a disparity in franchise agreements? Franchise contracts are notoriously one-sided. This imbalance can be attributed in part to a significant difference

in bargaining power during the initiation of the agreement. It can also be partially attributed to the motivations and incentives of the franchisee in signing a franchise contract. Their perceived need for protection may under represent the protections that they actually need. Therefore, the prospective franchisee may not be pursuing the contractual terms that would be in their long-term interest. Or, and we will examine this further, the needs of a franchisee in terms of contractual protections may not be particularly great, and the typical franchisor-friendly contract may actually reflect a balanced and free-market sculpted arrangement that has resulted from the competitive forces of many franchisors and prospective franchisees in the US. This can be considered in the context of two prominent economic strategy paradigms: the resource-based view of the firm (RBV), and transaction cost economics (TCE). These paradigms would regard the standardized contract offered to a potential franchisee as acceptable at face value if it has withstood market forces. (Argyres & Bercovitz, 2008)

Nevertheless, in forming the contract, bargaining power plays a role in granting the franchisor the ability to shift the contractual terms in its favor. Typically, a franchisor has more resources than the prospective franchisee. As an established company, they have access to legal advice and information unavailable to a franchisee. (Hess, 1995) Further, any franchisor that has been in business for some amount of time can draw on its own past experience in optimizing the terms of the agreement to suit the company's needs. A franchisee is faced with a take-it-or-leave-it decision in signing the contract. That is, the contract is offered in a standardized form, and there is little room no matter the resources of the prospective franchisee to affect the terms of the agreement. With little capability for negotiation, a franchisee usually must decide between taking the contract on the

franchisor's terms or declining to sign the agreement. The prospect of declining to sign the agreement and choosing another franchisor, though, could ultimately affect the capability of a franchisor to write a heavily franchisor-favored contract. One might argue that the wide availability of potential franchises would limit the one-sidedness of franchise contracts, as securing the best franchisees would require providing reasonable provisions to franchisees in the contract, lest the franchisor would be unable to secure the required or desired number of new franchise contracts.

But, does this competition actually affect the ability of the franchisor to use one-sided contracts? It is true that a prospective franchisee has thousands of choices. The *Bond's Franchise Guide,* released each year, details information on over 1,000 franchise systems. However, Bradach and Kaufmann (1988) and Kaufmann and Stanworth (1995) both found that the majority of franchisees self-select an industry or sector first, and then choose a franchisor within that category. (Blair & Lafontaine, 2005) Even so, there is wide selection of franchisors within most given categories. And, Kaufmann and Stanworth (1995) cite a study conducted by a prominent U.S. franchisor that found 75% of the chain's franchisees had considered alternative categories of franchised businesses.

In order for the competitive forces of a wide availability of potential franchise chains to actually affect the terms of the franchise contract, the prospective franchisees must be able to comprehend the effects that contractual terms have on their investment and be able to compare different franchise offerings in an educated manner. Otherwise, the competitive effect of multiple franchisors vying for prospective franchisees will be moot. They will not need to respond to competition by altering the terms of their contract to

make it more favorable for the franchisee, because the franchisee would not be informed enough to appreciate this adjustment. Thus, for the competitive forces to be relevant, a prospective franchisee must be able to compare the anticipated profit flows that each affords, or the net present value of each franchise opportunity. (Blair & Lafontaine, 2005) This calculation is anything but concrete, as it involves forecasting future revenues and costs, comparing the difference in the initial franchise fees and ongoing royalties, as well as including the affects of the terms of the franchise contract on the potential profit streams afforded by each opportunity. For instance, one pizza franchise may require that all ingredients be purchased through approved suppliers while another allows ingredients to be freely purchased. This restriction will likely have some effect on the ingredient expenses because the pizza franchise may extract profits from being the sole provider of ingredients to its franchisees. Thus, the pizza franchisee who is allowed to purchase ingredients on the free market may be able to enjoy lower prices than his/her competitor. Attempting to forecast this effect, and then discounting it back to the net present value of the investment requires both a well-informed and sophisticated prospective franchisee. And, it is not reasonable to assume that even a majority of prospective franchisees would have the capability to reasonably extrapolate the effects of different contractual terms on the net present value of different franchise opportunities. Further, even if a franchisee was sophisticated enough to perform this sort of estimation and forecasting, it is commonly true that the information disclosed in the initial franchise documents is not sufficient to perform comprehensive life-cycle cost calculations. (Blair & Lafontaine, 2005) In a 1996-97 case entitled *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, Domino's required that its franchisees buy the necessary ingredients and supplies from a Domino's Pizza-approved

(DPI) supplier. Queen City Pizza and ten other franchisees sued DPI on the basis of post-contractual abuse of power. They argued that the initial contract allowed the franchisees to anticipate getting reliable and competitive sources of ingredients approved by DPI. However, in DPI's refusal to approve competitive sources of supply, they shifted the balance of power in the contract in a way that could not be adequately anticipated pre-contract. Thus, DPI exploited its franchisees using post-contractual power directly related to the terms of the contract in a way that could not be fully comprehended pre-contract.

Additionally, only 25 percent of franchisors provided earnings and profit projections as part of their disclosure documentation, according to a 2000 study conducted by the IFA Educational Foundation and Frandata. Profit projections also need to be tailored to the demographic and economic characteristics of the trade area surrounding the proposed location. (Blair & Lafontaine, 2005) Some franchisors provide exaggerated or misleading oral profit or revenue claims, further adding to the difficulty of determining the best franchise to invest in. Ultimately, a prospective franchisee faces tremendous difficulty in accurately evaluating the viability of alternative franchisors. This facilitates pre-contractual opportunism by the franchisor in writing the terms of the agreement to heavily favor its interests, because the competition across franchisors for prospective franchisees is far from transparent, even with the help of a lawyer in evaluating the terms of each contract.

Also, after pursuing a time-consuming franchise discovery and approval process to get to the point of negotiating a tangible contract, it would be costly for the prospective franchisee to decline the contract and restart the discovery process with a different

franchisor (probably only to face another similarly imbalanced contract). Thus, a franchisee has little alternative to accepting franchisor-friendly terms, which are common across franchisors, in pursuit of owning a franchised business.

Alongside one-sided contracts, the structure of the franchise agreement also lends itself to an imbalance of power in the relationship in favor of the franchisor. As the relationship progresses, the capital and time investment of the franchisee increases. In the case of a sole proprietor as a franchisee, it is not an uncommon occurrence that the owner shifts careers and the franchise becomes the primary or sole source of income. Even when the franchisee is a partnership or even a corporation, they are typically much more vested in the success of that specific franchise than is the franchisor. The franchisee becomes dependent and grows more likely to acquiesce to the demands of the franchisor. This inevitable structural dependency makes abuses of power and opportunism by the franchisor more likely. It should be acknowledged that the potential franchisee should be able to weed out particularly notorious franchisors in terms of abuses of power. It would be wise for a franchisee to avoid franchisors who have been repeatedly sued, or otherwise have a poor reputation. However, this is not always easy to ascertain from the disclosure documents, as will be covered later in the paper.

These imbalances are critical flaws in the franchise industry. The franchisor has tremendous market power in the post-contractual relationship. This market power manifests itself through the ability of the franchisor to impose limitations on output and restrictions on business that would not be feasible in a purely competitive non-contractual business environment. (Kirkconnell, 2006) It lends itself to anti-competitive behavior. For

instance, a franchisor will change its policies and requirements once it has locked-in franchise investors through franchise agreements. Since franchisees are effectively locked into the franchise relationship, franchisors have relational market power over franchisees. Some other forms of abuse include:

- Lack of pre-contract disclosure
- Deceptive practices, including misrepresentation of the franchise, the range of supplies, equipment and training to be provided in the franchise package, the value and profitability of the franchise and the franchisor's stability and prior experience
- Unfair contractual terms arising from a refusal to negotiate
- Excessive prices charged for mandatory goods and equipment supplied by franchisors or other providers to franchisees, even when items are available more cheaply from alternative suppliers
- Secret rebates and commissions received by franchisors from required suppliers
- Encroachment by the franchisor on the franchisee's geographic trading area
- Franchisor-imposed system wide changes that bear significant cost
- Failure to provide adequate service and support to franchisees
- Substantial increases in renewal fees
- Use of advertising levies for non-advertising purposes
- Transfer and renewal restrictions and renewals on different and more onerous terms
- Unfair, unanticipated, or unreasonable terminations or nonrenewal (Manitoba Law Reform Commission, 2009)

These vulnerabilities speak to a need for regulation in ensuring adequate protection for the franchisee, which is not afforded through market forces. In these cases, a franchisor benefits at the expense of the franchisee. One reason why this occurs is that a franchisor may gain financially when an investor opens a new outlet, perhaps even if that outlet fails. (Manitoba Law Reform Commission, 2009) Further, the structurally inherent propensity for anti-competitive behavior suggests that franchising may struggle as an industry, in a free-market environment, through reduced profitability and long-term business sustainability in competition with non-franchised businesses. This difference in individual versus industry incentives resembles the quandary in the recent global recession. Economists speak of the need for increased consumer spending to incite a stronger recovery. However, an individual is best served by restricting her/his own spending to ride out the recession, rather than bolstering the economy by "contributing" to a collective increase in consumer spending. In the same way, it may be in the interest of an individual franchisor to impose restrictions or take advantage of their market power to enhance their own short-term profitability, whereas it is in the interest of the franchise industry's long-term viability to limit anti-competitive behavior. Just as a fiscal stimulus is the government acting as a correctional external force in restoring the stability of the economy, it seems necessary for there to be some degree of government influence in the form of regulations to correct anti-competitive behavior and discourage exploitation of relational market power and other abuse in the franchise relationship.

In considering where this relational market power is founded, there are a few particularly significant terms within a franchise contract: termination clauses, nonrenewal clauses, encroachment stipulations, and the right to transfer ownership.

A. Termination

Frandata and the IFA Educational Foundation cite an average duration of a franchise contract to be 10.3 years (1998). A franchisee typically expects a reasonably long duration and regards the franchise as their business, a tangible asset. It usually takes a number of years for a franchisee to begin to fully recoup their initial investment, so it is vital that they can rely on a reasonable length of time to make the investment viable.

As a result, the right of early termination is an important aspect of the franchise agreement, as this could easily prevent the franchisee from enjoying any return on their investment of time and money. Why is termination power important to a franchisor? Franchisors claim that termination power allows them to protect the value of their trademark and ensure uniform standards of quality across all franchises. Without an unrestricted ability to terminate, they argue that they are not properly equipped to protect their brand by eliminating negligent franchisees that may be free riding on the trademark or in some other way denigrating the brand image. There is also an economic argument for unrestricted termination power in a franchise agreement. It reduces quality-control costs, as the franchisee is heavily vested in ensuring that they don't fail to meet standards and face early termination of their license.

It is in the franchisee's interest, though, to have contractual restrictions on termination, to protect against arbitrary termination of a business in which the franchisee

has invested large amounts of time and capital. Also, even without the threat of termination, the franchisee is motivated to maintain high standards of quality and service, in order to maximize profits and maintain the opportunity for renewal of the contract. (Hess, 1995) In this regard, regulations should prevent the franchisor from terminating without good cause. The Iowa Franchise Act defines this good cause as "any legitimate business reason" which includes "failure of the franchisee to comply with any material lawful requirement of the franchise agreement." The Iowa Act also provides the franchisee the opportunity to rectify or "cure" the issue, in order to avoid early termination. This is a reasonable basis for further franchise regulation, as it protects the interests of both parties. However, "any legitimate business reason" may be too expansive a term, as it would possibly allow a franchisor to terminate a franchise simply for internal reasons regardless of the specific franchisees' actions. In any case, the unrestricted right to terminate in a franchise contract would open the door for post-contractual opportunism by the franchisor and would leave the franchisee vulnerable. For instance, the franchisor may terminate a particularly profitable franchise location in order to open its own location in the market and extract the additional profits. Franchisees should be protected from this sort of opportunism and should demand some restrictions on the right to terminate, either within the contract or externally via regulations. However, it is also important that termination be an option in the case of a negligent or free riding franchisee, so that a franchisor can properly enforce performance and quality standards on its franchisees and protect its brand image.

B. Nonrenewal

Nonrenewal is another term of particular interest to franchisors in writing franchise contracts. This affords the franchisor the ability to protect their trademark, similar to termination clauses. Also, franchisors claim that the option of nonrenewal is important so that they can respond to changing market circumstances that they could not anticipate at the onset of the contract. They may obligate the franchisee to acquiesce to significant changes in royalty payments, rents, or other changes in the contract before renewing the license. However, this may open the possibility for abuse by the franchisor, in coercing a franchisee to accept less favorable terms when they are already heavily vested in the continuation of the franchise. In *The Economics of Franchising*, it was concluded that the benefit of mistreating franchisees through non-renewals or renewals under unfavorable terms is typically low, and the costs of doing so can be quite high. (Blair & Lafontaine, 2005) This would lead to the conclusion that the unrestricted ability of non-renewals may not be a particularly onerous threat to the franchisee, as forces outside the contractual terms affect the franchisors behavior in this regard and serve to protect the interests of the franchisee. However, others still claim that wide discretion for the franchisor to refuse renewal creates a large opportunity for abuse. (Hess, 1995) In *Ziegler Co. v. Rexnord, Inc.* (Wisconsin, 1998), the courts set a precedent that strikes a reasonable balance between the interests of both parties. The franchisor predicated renewal of the license on the franchisee switching from buying and selling directly to selling on commission. The court stated that this was a reasonable demand by the franchisor, so long as the required changes are "essential, reasonable and nondiscriminatory between situated [franchisees]." This protects the franchisors interests because it recognizes that, in initiating a franchise

agreement, the franchisor is not forced into perpetuity of licensing, and that there is no "duty of self-sacrifice" (*Ziegler,* 1998) upon franchisors. At the same time, it protects against unrestricted abuse by the franchisor by requiring that forcing changes in terms upon franchisees at the time of renewal is only allowable when the franchisor acts out of necessity and treats all similarly situated franchisees in the same manner. (Hess, 1995)

C. Encroachment

Encroachment refers to new franchise locations from the same parent franchisor being opened within close enough a proximity to a franchisee that they lose sales that transfer to the new location. There is significant disparity between the economic incentives of the consumer, the franchisor, and the franchisee in terms of how much territory each location should be granted. The consumer would be best served, in a purely economic sense, by smaller territories and closer proximity. The franchisor is best served by a distribution of stores dense enough to maximize revenue and consequent royalties. Whereas, each individual franchisee would like to maintain a large enough territory without same-franchise competition in order to capture the most customers and maximize that individual outlet's profits.

Should the franchisee be granted exclusive territory, and how large should it be? Should a franchisor be allowed to saturate a market in order to maximize overall revenue, even at the expense of forcing some of its individual franchisees out of business? A franchisor should be motivated to ensure, in most cases, that its franchisors don't go out of business. In attempting to maximize revenue and royalties, it would be counterproductive for the franchisor to approve so many new franchises in a market that some of the outlets

are forced out of business. However, saturating the market to the point of zero profit per store would not reasonably fulfill the expectations of the individual franchisees. Thus, some level of protection against unreasonable saturation of a market is necessary. The Iowa Franchise Act attempts to address the issue of encroachment, but ultimately affords little protection to the franchisee and places a heavy burden of interpretation upon the courts. It states that a new franchise cannot be placed within unreasonable proximity of an existing franchise, unless the franchisor grants a right of first refusal to the franchisee or pays the franchisee for the diverted market share. (Hess, 1995) This is very nebulous, and there is no way to determine what is meant by unreasonable proximity, nor is there any way of determining precisely how much the franchisor should pay for the diverted market share. A critique of the Iowa Franchise Act provides a seemingly reasonable, albeit somewhat arbitrary, benchmark that placement of a new franchise or company-owned outlet in a location that would directly cause the reduction of gross sales of an existing outlet by ten percent or more is unreasonable. (Hess, 1995) Perhaps further and more specific economic research is needed to determine what a truly reasonable benchmark is, but it would be a step in the right direction. It protects the franchisee against egregious encroachment, while still allowing the franchisor to further its own interests in opening new outlets that may have a small or negligible effect on sales of other outlets in the franchise network.

III. Regulatory Environment

A. U.S. Federal and State Franchise Regulations

1. Categories of Franchise Regulations

Franchise regulations are divided into two categories: relationship laws and disclosure laws. Disclosure laws govern the provision of information prior to the initiation of a franchise agreement. They stipulate the specific information that must be provided, the format of that information, and the minimum amount of time prior to signing the contract that the information must be provided. For example, some laws dictate a seven-day waiting period between when the information is disclosed and when the franchise relationship can be formalized. This waiting period prevents franchisors from skirting disclosure requirements by providing critical information at the last minute, without proper time for the franchisee to review it before signing the contract. Disclosure laws do not govern the ongoing relationship.

Relationship laws regulate the ongoing franchise relationship including but not limited to termination, renewal, and transfer of the franchise. (Hess, 1995) At the federal level in the United States, there are limited regulations regarding franchising. In 1979, the Federal Trade Commission (FTC) passed a law requiring disclosure of certain terms by the franchisor to prospective franchisees. (Hess, 1995) The disclosure documents in the franchise industry are commonly referred to as the Uniform Franchise Offering Circular (UFOC) or Franchise Disclosure Document (FDD.) Passing of this federal regulation was beneficial in that it served to push towards standardization in franchise disclosure versus large variances under differing state law requirements prior to 1979. As touched on

earlier, the goal of this is to curb pre-contract opportunism and mitigate the inherent information inequity between franchisor and prospective franchisee. This is merely a disclosure requirement, and does not cover any part of the ongoing relationship.

2. Common Law Governance

More generally, what governs a franchise agreement? Since it is legally a contract, parties in a franchise relationship can seek protection under common-law contractual rules. In states without franchise regulations, common law is the only source of protection for the franchisor and more significantly, the franchisee. Historically, franchisees have tried to use three common-law principles to garner legal protection: creation of a fiduciary duty, unconscionability, and the implied duty of good faith and fair dealing. (Hess, 1995)

Fiduciary duty refers to an established responsibility that the franchisor has for the franchisee. Various franchisees have attempted to gain legal protection through the courts by asserting an established fiduciary duty. However, courts have yet to recognize the existence of fiduciary duty in the franchise relationship. Thus, this is not a viable mechanism for enforcing the rights of the franchisee/franchisor under common law.

Some franchisees have attempted to prove that terms of their franchise agreement are unconscionable. However, legally, unconscionability only applies when there is evidence of fraud or oppression up until the franchise agreement was formed. (Hess, 1995) As such, problems that arise in the ongoing franchise relationship do not qualify under the principle of unconscionability. Thus, unconscionability is also not a viable mechanism for enforcing the rights of the franchisee/franchisor under common law.

The implied duty of good faith and fair dealing has proven to be the most successful, albeit still limited, as a mechanism for applying common law to the franchise relationship. For a franchisee, they must prove that the franchisor has in some way breached the implied duty of good faith and fair dealing. (Hess, 1995) This is the right of each party to benefit from the contract. However, using this duty to govern a franchise relationship is necessarily limited because it is an implied term, and is superseded by explicit terms of the franchise contract. Thus, it only applies to nebulous or unclear portions of a franchise contract, and cannot directly contradict the explicit stipulations of the contract. Typically, this duty has only been applied by the courts to limit a franchisor's discretion, and not for any more substantive rulings. (Hess, 1995) Another significant problem with utilizing this duty to govern a franchise relationship is that the protection is inversely related to the comprehensiveness of the contract. As discussed earlier, franchise agreements are notoriously one-sided in favor of the franchisor. If a franchisor writes a wholly comprehensive and one-sided franchise contract, then the franchisee has little room for protection under the implied duty of good faith and fair dealing. Common-law provisions for governing a franchise relationship are insufficient, and legislation more specifically related to the franchise relationship is needed to protect the interests of both parties.

3. Federal Trade Commission (FTC) Franchise Rule

The Federal Trade Commission's Franchise Rule is a disclosure law. It requires that the franchisor inform prospective franchisees of twenty items of information, including among other things:

- Litigation history of the franchisor

- Initial and recurring funds required to be paid by the franchisee
- An obligations to purchase owed by the franchisee
- Financing arrangements
- Restrictions on sales by the franchisee
- Required training programs
- Conditions for termination of the franchise agreement
- Conditions for nonrenewal or renewal of the franchise at the end of the stipulated term
- Statistical information regarding the number of franchises in the franchisor's network
- Financial information on the franchisor (Burke & Abel, 2003)

Critics of the FTC rule argue that the disclosure requirements are not sufficient to protect the franchisee. Debra Burke and Malcom Abel point out that the Rule leaves out some key pieces of information, without which the franchisee's decision to sign the contract is inherently uninformed. The Rule does not require franchisors to disclose how many or how often their franchised locations close or go bankrupt, nor the income statements of other franchisees. Franchisors are required to disclose the number of franchises in the previous year that were terminated, not renewed, reacquired by the franchisor by purchase, or for any other reason cancelled or terminated. (Burke & Abel, 2003) They go on to argue, though, that this information is not complete enough to give the franchisee a full grasp of the rate of failure and reasons for potential failure among the company's franchises.

The requirement to disclose income information does not need to be categorized, so that a potential franchisee will only be able to guess as to whether revenues from franchise fees fall into the cash, account receivables, or uncollectible category. Surveys have indicated that most potential franchisees experience difficulty enough comprehending the disclosure statement, and that most are incapable of utilizing that information to make sophisticated guesses about the health of the franchise network, failure rate of the franchisees, and other vital information. In fact, the court system formally recognizes that smaller investors (franchisees) do not have the requisite "sophistication" to fully understand the balance sheet and income information they are given as part of the required disclosure documents. It is clear from the recent proposed revisions to the FTC Rule that it is these investors that the Rule is designed to protect. These revisions propose relieving franchisors from the disclosure requirements if the investment of the franchisee is over $1.5 million. The courts are using the size of the investment as a measure of sophistication of the franchisee. (Franchise Rule, 64 Fed. Reg. 57,320-57,321) It would be reasonable to expect that if the courts recognize the lacking sophistication of a potential franchisee, the disclosure requirements should be so comprehensive that any sort of assumed complex financial analysis or otherwise interpretation of the provided disclosure documents should not be needed in order to glean necessary pieces of information about the franchisor. These pieces of information should include: overall and recent failure rates of the franchises, the full operating history of the franchise network (including buybacks by the franchisor, sales, transfers of ownership, bankruptcies, closures, and other significant events that point to the operational sustainability or lack thereof in the potential franchised business), documented income information and time-to-profitability of franchise locations,

and rates of renewal and nonrenewal for expired franchise contracts. This is justifiable, because, in operating a franchise, the franchisor is clearly in the best position to gather and maintain all of this information regarding their network of franchises without placing too much of a burden on the franchisor. Further, the franchisor should benefit from documenting this information, and it should be reasonably expected that they then pass it along to prospective franchisees, whom are in no position to gather that depth or breadth of information independently.

Unfortunately, under the current FTC rule, leaving the burden of information gathering up to each individual prospective franchisee largely seems to be the case. In fact, less than fifteen percent of all registered franchise offerings make representations regarding potential sales, income, and profit pursuant to the current mandated form for disclosing this information in writing. Franchisors are exploiting a loophole, which makes disclosing this financial performance information entirely optional. Instead, they opt to make oral claims regarding the performance of their franchise. With oral claims, the franchisor is not accountable to its accuracy, nor is it documented anywhere. And, these oral claims have proven to be inadmissible in fraud proceedings, even if they are blatantly inaccurate. (Burke & Abel, 2003) Addressing this loophole and the incomplete disclosure requirements should be an important aspect of franchise regulation reform in the US.

Advocates for reform cite a 1992 General Accounting Office audit of enforcement activities, which discovered that the FTC was only investigating six percent of complaints that claimed significant violations of the Rule. Under the FTC Rule, the FTC is to investigate and provide remedies, such as cease and desist orders, freezing assets of franchisors,

issuing judgments, and seeking criminal sanctions, in the case of violations of the Rule. (Burke & Abel, 2003) Clearly, only limited resources are available, and proper redress is heavily rationed. In addition, the Rule does not allow for private recourse for violations. Since FTC action is the only avenue for addressing violations, the Rule is not able to effectively regulate pre-sale disclosure.

The FTC Rule is closely modeled to the Security and Exchange Commission's various disclosure laws regarding investment in securities and public exchanges. The SEC's disclosure laws contain both provisions for enforcement actions by the SEC in addition to private causes of action. Professor Robert Emerson argues that it is incongruous that investments in franchises do not carry a similar federal private right, particularly because franchisees do not just risk an investment of capital, but their livelihoods as well. Reform of the FTC Rule must address this, and provide for private causes of action in addition to FTC enforcement actions.

4. State Franchise Regulations

Aside from federal regulations on franchising, there are also state-specific laws. The FTC Rule, though, has been used nationwide as a justification for complacency in franchise law reform. As such, very few states have enacted any sort of franchising statute that is more stringent than the FTC Rule since 1980. And, some states have actually scaled back franchise laws. For instance, Michigan repealed its registration requirement in 1984, and now only requires a basic document stating the franchisor's name and business address. Prior to 1984, Michigan required registration and review by state regulators prior to a franchisor conducting business in the state.

Some states do provide protection greater than that of the federal laws. Some require registration, as Michigan used to, and some grant franchisees a private cause of action for violations of state franchising laws. (Burke & Abel, 2003) The scope and completeness of registration requirements varies greatly. Some states review disclosure documents in order to detect fraudulent or abusive proposals. Under New York's Franchise Sales Act, for instance, a franchisor must submit a prospectus to the Attorney General's office for review before it can be used in the pubic offer and sale of the franchise (FTC Franchise Regulation Hearing, 1991). In some states, though, registration documents are only reviewed in the case of some complaint or investigation. In this case, the registration requirement serve more as a backup means of gathering evidence for court proceedings and investigations, and not as a means of actively protecting the franchisees' investment.

Some states provide for a cause of action to franchisees in the case of a franchisor violating disclosure or registration stipulations, falsifying information, or omitting material facts. (Burke & Abel, 2003) Some actions that can be taken to provide remedy are: rescission of the franchise agreement, damages, attorneys' fees and costs, and injunctive relief. States that require registration include: California, Hawaii, Illinois, Indiana, Maryland, New Jersey, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, Wisconsin.

There also nineteen states that regulate the ongoing franchise regulation in some way. These regulations impose limitations on the franchisor, such as: franchisor's ability to terminate or not renew a contract, franchisor's right to disapprove of franchise ownership

transfers, limitations on where new franchises can be authorized based on encroachment protection, and freedom of association amongst franchisees. (Barkoff, 2009)

In the words of an anonymous commentator quoted in a 1996 publication entitled "Fair Franchising Standards," "the FTC Rule has gone a long way toward eradicating massive franchise frauds and, by doing so, have restored franchising's reputation for integrity and thus cleared the marketplace for the offerings of legitimate franchisors. A recent law review article goes on to claim that the rule has significantly altered the balance of power between franchisees and franchisors, thereby greatly reducing the need for draconian state measures. (Berry, Byers, & Oates, 2009) However, the FTC Rule is not sufficient in addressing the reasonable expectations of both parties. And, perhaps as a result of the existence of federal regulations, or for any other reason, the majority of states have not passed any franchising laws that provide coverage above and beyond that in the FTC Rule. An incomplete disclosure law from the 1970s has provided the political means for the franchisor lobby to oppose and successfully prevent more comprehensive federal or state reforms from taking place. It is out of the course of this paper to address whether federal or state reform is preferable, but bringing to light the insufficiency of the current regulatory environment is necessary in spurring reform that will lead to better and more comprehensive protections for the franchisee, while still recognizing and allowing for the need of franchisors to protect their own interests, including the prevention of "franchisee freeloading" and other risks that franchisees pose to a franchisor.

5. Uniform Franchise Offering Circular (UFOC)

The UFOC signifies one of the most significant benefits that have come from states enacting more stringent disclosure requirements. In 1974, the Midwest Securities Administrators Association developed what would come to be known as the Uniform Franchise Offering Circular or Franchise Disclosure Document. Up until this point, disclosure requirements varied from state to state and there was no standardized method of meeting each state's disclosure requirement. When the FTC Rule was introduced in 1979, it included its own proposed format for franchisor disclosure called the FTC format. However, only Illinois approved the FTC format as sufficient for its own disclosure requirements. As such, the UFOC became the franchising standard for disclosure that would meet both federal and state regulations. This simplified the disclosure process for franchisors and made the process much more efficient. It also maintains predictability in disclosure across franchisors, which is helpful to prospective franchisees comparing multiple franchises. The fact that states had introduced more stringent disclosure requirements than the federal government lead to the creation of the UFOC, which ultimately exceeds the disclosure requirements of the FTC Rule.

Interestingly, the most recent revision to the FTC Rule has embraced the UFOC format, and requires exclusive use of it in pre-sales disclosure. However, the UFOC under the new FTC Rule, which went into full effect in 2008, is not entirely similar to the old voluntary UFOC. For example, the new UFOC has a number of disclosure requirements that were not present in either the old FTC Rule or any state disclosure requirements. Some of the new requirements include:

- A summary of all material litigation commenced by franchise systems against their franchisees over the prior year (currently, only franchisee litigation against franchise companies is required to be disclosed).
- Disclosure of all government litigation against any franchise firm or affiliate which sold franchises in any line of business within the past 10 years.
- A statement as to whether any officer of the franchise system owns an interest in any supplier that franchisees are required to do business with.
- Expanded disclosures regarding how the franchise company or an affiliate may compete with franchisees through alternative channels of distribution.
- If no territorial rights are conferred upon franchisees, a special disclosure warning of possible adverse consequences.
- A clear explanation of what the term "renewal" means in the subject franchise system.
- Requires financial performance representation preambles, to the effect that the law permits franchise firms to make financial performance representations in their disclosure documents and that, if none appear, any representations otherwise forthcoming from franchise company personnel about past or projected franchise revenues or profits should be disregarded and instead reported to government agencies.
- Whether a franchise unit may have been the subject of "churning" activity (the repeated sale of the same unit to different franchisees at different times).
- Whether franchisees are restricted from speaking freely to prospective franchisees about the former's experiences by virtue of any confidentiality agreement.

- Identification of both "captive" franchise associations (those sponsored and or endorsed by the franchise system) as well as "independent" franchise associations (which, to be disclosed, must be network-specific, organized under state law and must annually request disclosure).

(Kaufmann, Embracing the Revised FTC Franchise Rule: The Countdown Has Begun, 2007)

The new UFOC is a significant improvement in stringency and completeness of disclosure requirements, and mandatory standardized disclosure is a move in the right direction. Despite this recent overhaul to the UFOC and the FTC Rule, many of the criticisms of the old system in franchise literature remain relevant. Critics contend that, even with the proposed modifications, the disclosure documents still require a great deal of sophistication to properly understand. And, the FTC Rule revisions did not include a private cause of action, meaning the law is still purely regulatory, and enforcement actions are limited to the capabilities of the FTC. In addition, triage of violations by the FTC will become increasingly necessary as the number of franchises in the United States continues to place additional enforcement burdens on the FTC, without proper increases in funding or manpower.

6. Reasonable Expectations for Future Franchise Law Reform

As addressed throughout this paper, there are a number of areas in which the current combination of market forces and government regulation does not sufficiently protect the interests of both parties. Ideally, in pursuit of economic efficiency, franchise laws would play a back-up role and only affect a franchise relationship in the case of market failure, when some egregious abuse or opportunism arises that either harms

economic efficiency or harms the well being and expectations of the franchisee or franchisor. (Hess, 1995) Thus, these regulations would allow market forces to play a primary role in guiding franchise relationships and would serve to promote economic efficiency.

Criticisms of current franchise regulation are significant. Some argue for a 'less is more' approach to franchise regulation:

"Because of the strong presence of lawyers with extensive experience on behalf of franchisors operating internationally, the frequent and well-intentioned efforts to inject more and more protections on behalf of the franchisee were tempered by the larger consideration that in the final analysis legislators could end up protecting the franchisees right out of a livelihood by introducing overly burdensome laws. Even worse, legislation might protect the economy right out of the jobs and wealth that franchising produces. Although the debate among franchisor and franchisee counsel and lobbyists continues about the legitimacy of the claim, Alberta's 1971 act and Iowa's present relationship law are cited as examples of the macroeconomic harm that over-burdensome regulation produces. In business, fear – no matter how irrational – is a deterrent." (Dillon, 2006)

David Hess, however, cites three compelling arguments for the need for proper franchise regulation in order to protect the interests of both parties. First, legislation can properly allocate costs between the parties. For instance, a franchisor is free to change its business model or distribution methods, so long as the costs to do so are incurred by the franchisor and are not destructive to the investment of the franchisee. This protects the

franchisee against opportunism, but also provides for an optimal allocation of risks that would take place in a market without the substantial bargaining-power disparity.

Second, legislation can promote the interests of both parties, not just the franchisee. Thoughtful legislation can solidify the franchisor-franchisee relationship, prevent arbitrary treatment, and give franchisees confidence to invest further in the franchise, which ultimately benefits the franchisor.

Third, from this paper and from studies such as the Iowa Franchise Regulation Interim Study Committee, it is proven that there are significant risks of opportunism and abuse within the franchising system. Reforming franchise laws to mitigate these risks by acknowledging common forms of abuse on both sides of the table will lead to regulation that only takes effect when the franchise agreement fails to protect the reasonable expectations of both parties. (Hess, 1995) Overall, this will lead to a healthier and more efficient franchising industry that will benefit all parties.

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