COMMENT ON PROPOSED U. S. FRANCHISE LEGISLATION: A SEARCH FOR BALANCE*

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In May 1992 two franchise bills were introduced by Rep. John J. LaFalce (NY) in the U.S. House of Representatives which, if enacted, would be of great significance to the business and franchise communities. The proposed Federal Franchise Disclosure and Consumer Protection Act ("FFDCPA") (H.R. 5232) would further regulate the offer and sale of business franchises. The proposed Federal Fair Franchise Practices Act ("FFPA") (H.R. 5233) would regulate the merits of business franchise relationships generally at the federal level for the first time. The legislation follows a two year study by the House Small Business Committee (chaired by Mr. LaFalce) of business franchising in the United States.[1]

Franchisors and their counsel have voiced vigorous opposition to these bills. In support, they cite the absence of reliable statistical information which demonstrates a need for such federal laws. They consider such legislation to be the quintessence of regulatory overkill which, if enacted, would sound the death knell for all of franchising. These views are consistent with their historical opposition to most franchise regulation.

Proponents of the bills point out that despite the impressive growth of franchising in the U.S. and global economies during the last twenty years, there exists a "dark side" of franchising consisting of abuses im-

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1. At the time of this writing, the FFDCPA was pending in the House Energy and Commerce Committee and may have gained an influential supporter, long-time incumbent and committee chairman Rep. John D. Dingell (D. Mich.) According to the *Continental Franchise Review* (11/6/92 at 1), Mr. Dingell co-authored a letter to the Federal Trade Commission with Mr. LaFalce expressing concern over the agency's enforcement of its trade regulation rule pertaining to franchising. Also, the FFPA (together with a similar bill (H.R. 5961) introduced in Congress by Rep. James H. Scheuer (D. N.Y.) on September 16, 1992) was pending before the same committee. According to Congressional sources, Mr. LaFalce's bills will be reintroduced in the 1993 Congressional session. It is not anticipated that Mr. Scheuer's bill will be reintroduced. Representatives LaFalce and Dingell were re-elected. Rep. Scheuer has retired.

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posed on franchisees by franchisors both before the franchise sale and during the franchise relationship. They cite fraudulent franchise offerings, troubled franchise systems and onerous one-sided franchise agreements which have brought hardship to consumer entrepreneurs. They suggest that uniform federal legislation is needed to provide more effective disclosure and better consumer protection in franchise offerings and to achieve greater fairness and equity in ongoing franchise relationships.

So far as these adversaries are concerned, one is either for or against legislation of this kind. Franchisor representatives oppose all franchise regulation for obvious reasons. Franchisee representatives seek comprehensive regulation to compensate for past injustices and to remedy perceived unfairness experienced by franchisees. Neither disputes the need for uniformity in franchise regulation. Still, each side apparently labors under the misperception that: (i) the other side's position (on all issues) has no merit; and (ii) any movement toward compromise will result in doom. Neither is correct. If anything, these bills should function as a starting point for meaningful discussion in an important forum of serious problems which face franchising today. The purpose of this article is to describe the contents of the bills and to comment briefly on them in a balanced manner in light of the current regulatory environment.

FEDERAL FRANCHISE DISCLOSURE AND CONSUMER PROTECTION ACT

Prompted by weak enforcement of existing federal law by the Federal Trade Commission and uneven state regulation, the proposed Federal Franchise Disclosure and Consumer Protection Act would prohibit fraud, deception and other misrepresentations and omissions in the franchise sales process including violation of the Federal Trade Commission's franchise disclosure rule.[2] Also, it would require additional mandatory disclosures, particularly regarding potential revenues, costs and earnings to be realized with a franchise and most significantly, furnish a private right of action for damages and equitable relief. Its goal is to achieve more effective public disclosure and strengthened consumer protection in the area of franchise sales.

FINDINGS AND PURPOSE

The FFDCPA proposes that the following findings be codified: (i) franchise business relationships represent a large and growing segment of

2. The FTC's trade regulation rule entitled: "Disclosure Requirements and Prohibitions Concerning Franchises and Business Opportunity Ventures," 16 CFR 436 (1978) was promulgated in December 1978 and effective in October 1979. It was intended to eradicate abuses in the offer and sale of franchises and to mandate disclosure to prospective franchisees of necessary information about franchisors and franchise opportunities so that they can make informed decisions on whether or not to purchase franchises. It is referred to herein as the "FTC Rule".

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America's retail and service businesses which are replacing traditional forms of small business ownership; (ii) because franchising is comparatively new in American business, existing law has not evolved sufficiently to protect consumer entrepreneurs from misrepresentation in the sale of franchise businesses and from fraudulent or poorly structured franchise opportunities; (iii) most prospects lack bargaining power and invest large amounts of money to obtain franchises for businesses and industries with which they have no familiarity; (iv) franchisees may suffer serious financial losses when franchise sellers provide false or incomplete information regarding the franchise opportunity and the franchisor; and (v) traditional legal remedies have proven inadequate to protect franchise purchasers due to the failure of some courts to recognize what inducements are material in a franchise sale and what contract terms are material in ongoing franchise relationships. There is substantial support for these findings.[3]

The purposes of the FFDCPA are: (i) to furnish consumers with information necessary to make informed investment decisions about franchise purchases; (ii) to protect them from fraud and deception; and (iii) to broaden the scope and enhance the availability and utility of common law remedies in order to promote more equitable franchise relationships.

PROHIBITED ACTIVITY

Prohibited actions under the FFDCPA fall within two broad categories. The first covers conduct prohibited by federal law elsewhere such as fraud, deceptive practices, misrepresentation of material facts and discrimination among prospective franchisees on the basis of race, sex, religion, disability or national origin, whether in the solicitation, offer or sale of franchises or in the selection of any site for a franchise business. The second covers specific prohibitions (similar to securities law violations) in current federal disclosure law making it unlawful for franchisors, in dealings with prospective franchisees to: (i) make an untrue statement of material fact or an omission of material fact; (ii) fail to furnish franchisees with all information required by current regulations (*e.g.*, the FTC Rule); (iii) fail to provide current information; and (iv) make claims or representations that contradict or are inconsistent with information provided in written disclosures required by law.

3. At a hearing conducted by the House Small Business Committee on July 21, 1992 on new developments in franchising, counsel for the International Franchise Association (a trade association of franchisors) charged that the committee has not produced any statistical evidence on the necessity of federal franchise legislation. This was countered by others who testified to the effect that significant problems exist in franchisee-franchisor relationships many of which derive from increasingly longer, more complex, one-sided franchise agreements and the continuing traditional approach of courts to resolve franchise disputes largely by looking to contracts and contract precedents for answers.

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STANDARDS OF MATERIAL OMISSIONS

The bill (FFDCPA Section 4(a)(1)-(13) incorporates significant specificity in describing material omissions in presale dealings between franchise sellers (including franchisors, franchise brokers and subfranchisors) and prospective franchisees. The new standards are intended to be in addition to disclosure of other facts, circumstances or sets of conditions required under state or federal law. It would be unlawful for franchise sellers to fail to furnish prospects with the following categories of information in the time and manner required by the FTC Rule. Each category must be commented upon positively or negatively in the required disclosure document. (FFDCPA Section 4(c))

Many of the categories of information to be disclosed under the FFDCPA must be disclosed (in whole or in part) under current disclosure law (the FTC Rule or the Uniform Franchise Offering Circular (UFOC) and UFOC Guidelines).[4] Normally such guidelines must be satisfied in order to comply with state registration and disclosure laws. The proposed bill increases franchisor obligations, however, by expanding the nature and scope of information which must be disclosed. The additional disclosures make sense in some cases. In others, however, the information sought to be disclosed would impose an undue burden on franchisors without providing real benefit to franchisees. Such burdens may precipitate harmful effects such as causing some franchisors to cease franchising and others to raise their franchise fees to cover the increased cost of legal compliance.

The categories of information for which disclosure may not be omitted are summarized below followed by brief comments.

> (i) identifying information including name and place of business for the franchisor, its predecessor, parent firm, holding company or other controlling entity and tradenames.

This is largely repetitive of current disclosure law.

> (ii) identifying information on principal franchisor personnel, franchise brokers and franchisor affiliates that provide products or services to the franchisor's franchisees or that otherwise are engaged in franchising.

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4. The UFOC and UFOC Guidelines were developed originally by the Midwest Securities Commissioners Association whose former responsibilities now lie with the North American Securities Administrators Association ("NASAA", particularly its Franchising and Business Opportunity Committee) to assist franchisors in developing a uniform format to allow them to comply with state laws requiring disclosure and registration prior to the sale of franchises. There have been a number of versions. The FTC has indicated that the September 2, 1975 version may be used to effect compliance with the FTC Rule. Generally, the UFOC and its Guidelines constitute a stricter disclosure standard for franchisors to comply with than the FTC Rule. Most franchisors utilize the UFOC disclosure format (as compared with the FTC Rule format) to achieve greater uniformity in their disclosure documents.

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This is substantially repetitive of current disclosure law with the exception that in addition, prospective franchisees must be informed of the franchisor's affiliates who have been engaged in franchising and/or who will be furnishing products or services to franchisees. The additional disclosures would be helpful to prospects while placing a minimal disclosure burden on franchisors.

> (iii) ten year litigation and arbitration history (past and pending material matters) for the franchisor, its significant personnel and affiliates.

While this is largely repetitive of current law, it incorporates significant changes. First, it adds a new category of discloseable litigation namely, any matter "brought by a present or former franchisee" (or a state or federal agency) "and which involves or involved franchise activities or the franchisee-franchisor relationship". Because such cases normally are of interest to prospective franchisees, they should be disclosed. The disclosure category should be expanded, however, to include like matters asserted by counterclaim by franchisees. Second, because during the last ten years or so many franchise disputes have been resolved by arbitration, the obligation to disclose material disputes in litigation *and* arbitration is appropriate. Some states already require disclosure of material arbitration proceedings. Third, the disclosure of pending individual civil actions is limited to those having a material impact on the franchisor or a franchisee as well as any group of civil actions which, irrespective of the materiality of any single such action, in the aggregate is material. This materiality standard should be replaced by one based on the viewpoint of the prospective franchisee, not that of the impact of the particular case on the franchisor or a franchisee. The relative financial size of a franchisor or a franchisee could render immaterial a case that many prospects would find significant even if a threatened damage award would not have a substantial balance sheet impact. Instead, an objective standard similar to that for deceptive trade practices should be used. The standard should be whether a reasonably prudent prospective franchisee would find the litigation disclosure an important fact which may cause him or her not to purchase the franchise.[5] A materiality standard very close to this one appears in the definitions section of the bill. (FFDCPA Section 12(11) For the foregoing reasons and to avoid inconsistency, the latter standard should be used.

> (iv) bankruptcy and insolvency history for the franchisor, such personnel and affiliates going back seven fiscal years.

This is largely repetitive of current disclosure law.

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5. *See Purity Supreme, Inc. v. Attorney General*, 380 Mass. 762, 777, 407 N.E.2d 297, 307 (1980) (deceptive failure to disclose material fact found where disclosure could reasonably be found to have caused one to act differently from the way he or she otherwise would have acted had the truth been known).

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> (v) how much money must be paid to the franchisor or its affiliates including franchisee payments they impose or collect in behalf of third parties: (a) to commence the franchise operation; and (b) to carry on its business.

Largely repetitive of current law, this disclosure addresses initial and recurring fees the franchisee must pay to the franchisor (its designees and affiliates) to begin and to carry on the franchised business. Also, it would require disclosure of real estate, services, products, inventory, signs, equipment and the like which the franchisee is required to buy from the franchisor or its affiliated designees and in addition, a description of the basis for calculating, and actual amounts, where available, of any revenue or other consideration to be received by the franchisor (or its affiliate) from any person from whom franchisees are required to make purchases.

Franchisors who collect hidden rebates from suppliers on franchisee purchases from them will oppose this provision vigorously. It should be included, however, because prospective franchisees should know before they buy how much money their franchisor will be receiving from them (directly *and* indirectly) and if the prices they pay for certain products or services are inflated because of such charges. On the other hand, franchisors who furnish legitimate mass purchasing benefits for their franchisees provide them with a useful service and should be entitled to a reasonable profit for it, which charges often are disclosed to prospects (albeit with a modicum of specificity) in the franchise sales process. The law would require disclosure of kickbacks, rebates and tied purchases with more specificity than is currently provided.

This omission standard and the FFDCPA are lacking, however, because they do not (as UFOC Item VII does) require that prospects be informed of the estimated *total* investment (whether payments are made to the franchisor, its affiliates *or* unaffiliated third parties), necessary to commence operation of the franchised business. The FTC Rule is equally deficient in this regard. Prospects need to know with as much detail as possible how much capital (whether equity or financed) they will need to establish and operate the franchised business until cash flow is estimated to be adequate to keep the business going without additonal capital infusions. The FFDCPA and the FTC Rule should be changed to eliminate this shortcoming.

> (vi) a statement of the services and assistance which the franchisor (and/or its affiliates) is obligated by contract to provide to the franchisee to commence the franchise business and to carry on such business including cautionary language stating that the franchisor is not obligated by contract to provide additional services to the franchisee.

This is largely repetitive of current disclosure law. The new cautionary language is not burdensome to the franchisor. Moreover it is moderately helpful to both sides because it puts all on notice that no additional franchisor services are required to be provided nor should the franchisee

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expect them.

> (vii) a description of the franchisor's trademarks and commercial symbols including specific information on registrations and any restrictions on the franchisor's right to license or the franchisee's right to use the marks.

Although it calls for more disclosure than is currently required under the FTC Rule, this disclosure of trademark-related information is insufficient. It falls short of that which is required to be disclosed under state law and the UFOC Guidelines, the standard with which most franchisors now comply in any event. For example, prospective franchisees should be informed of material infringing uses of the marks. They should be told if their franchisor will or will not compensate them for any loss they may suffer as a result of use of the mark (or a confusingly similar one) by an unauthorized third party. Moreover, they should know if the franchisor does or does not agree to indemnify them and/or protect them if they suffer loss or damage from their use of the mark in the manner directed by the franchisor. This information is important to prospective franchisees. The disclosure places little additional burden on franchisors, because most follow the UFOC format.

> (viii) a statement describing any limitations (whether by contract or practice) on the franchisee in terms of the goods or services which may be offered for sale or sold, the customers with whom the franchisee may deal or the geographic area in which the franchisee may offer or sell same.

This is largely repetitive of disclosures required under state law and the UFOC Guidelines. The limitations are important for all parties and the disclosures are material to prospective franchisees. Because most franchisors comply with federal and state law by satisfying the UFOC requirements this disclosure places no undue added burden on franchisors.

> (ix) a statement describing any territorial rights to be granted to the franchisee whereby the franchisee will be protected from competition by the franchisor under the same or different marks, whether by the establishment of franchised or company-owned (or affiliated) units or through the offer or sale of competing goods or services through other distribution channels. Such information must be disclosed for a franchisee's local market area whether or not protective rights are granted to the franchisee.

This is largely repetitive of disclosures required under state law and the UFOC Guidelines. Territorial protection rights (and exclusions therefrom) are important to all parties. These disclosures are material to prospective franchisees who have a right to know of the various forms of competition they can expect from the franchisor, whether under the same or different marks and whether through similar or different distribution channels. In addition, franchisors who seek to reserve the right to so compete will be better protected by such disclosures if they elect to

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exercise these rights after the franchises are sold. There is a modest additional burden on franchisors over current law in that these disclosures must be addressed to the franchisee's local market area *whether or not* the franchisee is granted territorial protection of some kind. Under current law, if the franchisee does not receive any exclusive territorial rights under the contract, such disclosures are not technically required. On the whole, however, because the information to be disclosed is important and because most franchisors comply by disclosing it in conformity with UFOC requirements, this disclosure places a reasonable burden on franchisors.

(x) a statement disclosing the existence of any written agreement or commitment or public expression of intention made by the franchisor, its officer, parent or controlling person to dispose of the franchisor or a controlling interest in it, and if an agreement or commitment for such a disposition has been made, identifying information about the purchaser.

Prospective franchisees need to know if the party with whom they are dealing and whom they reasonably believe will be their franchisor is about to be sold to a third party about whom they know nothing. Bitter disputes have arisen over such omissions in the franchise sales context. Existing franchisees contemplating the establishment of additional units or significant additional capital investment also have a serious interest in this information. Clearly, mergers and acquisitions of the type contemplated by this part of the bill are to be handled with delicacy and secrecy for obvious reasons. The bill, however, does not require disclosure of preliminary negotiations, discussions or offers. It requires disclosure of agreements and commitments as well as expressions of intent which are in the public domain. Accordingly, such information should be disclosed to prospective franchisees. If such disclosure would cause a franchisor harm, then it should refrain from offering, granting or selling its franchises until the difficulty is resolved.

(xi) a compulsory (with certain exceptions described below)
"earnings claim", namely, a statement outlining a specific level or range of potential sales, costs, income, gross or net profits that a franchisee can reasonably expect to attain through owning and operating the franchise which: (a) has a factual basis in operating data (revenues and expenses) derived from similar (same trademarks, products and services) franchised or non-franchised outlets of the franchisor (with exceptions for immature franchisors and for sales of specific outlets); (b) has a reasonable basis for all representations regarding actual or projected sales, costs, income or profits for such units; (c) includes a concise description of the factual bases and material assumptions on which the statement is based (including a disclosure of whether the representations are based on actual experience of franchised outlets of the franchisor and the number and percentage of franchised outlets operating during the period covered by the representations which have attained or surpassed the results stated); (d) is included in full in the disclosure statement given to the prospective franchisee within

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the time required by the FTC Rule; (e) is amended as necessary to reflect changed facts or to incorporate changes which the franchisor knows or should know render the statement no longer reflective of the operating experience of franchised units; and (f) states that substantiating data will be made available to prospective franchisees on request. There are two exceptions from this mandatory disclosure. First, new or immature franchisors (*e.g.* those engaged in franchise activities for less than two years or with no more than ten outlets (franchised and/or company-owned) or no more than five franchised outlets to provide a basis for the data) need not provide this statement. Second, a franchisor providing representations limited solely to the actual operating results of a specific outlet offered for sale need not make the "earnings claim" statement if the representation about the specific outlet is in writing, given only to prospective purchasers of the specific outlet and is accompanied by the names and last known addresses of each of the outlet's prior owners during the previous five years. Also, if the franchisor chooses to furnish the statement in such circumstances, there is another exception to the general rule that no additional "earnings claim" type information be disseminated, which is that a supplemental statement of actual results for a specific outlet or directed to particular circumstances of a specific location may be made available to prospects provided that it is in writing and that it explains any departure (and the reasons therefor) from the information provided in the disclosure document.

This is a major departure from current disclosure law in that it would require most franchisors affirmatively to furnish "earnings claim" information to prospects. Prospects need reliable information in this area. As proposed, however, this requirement would pose a serious problem for franchisors because it would increase their compliance costs *and* their risk of being sued for giving out inaccurate or incomplete information to prospective franchisees.

Without doubt, franchise prospects want to know more than anything else how much money they can make if they buy a franchise. Currently, if franchisors choose to disclose such information, they must do so in a manner fairly consistent with the foregoing requirements (*e.g.* a reasonable factual basis (though not necessarily derived from data from franchised or nonfranchised outlets of the franchisor offering the same products or services and under the mark to be licensed to the prospective franchisee); included in full in the disclosure document; with a description of its bases and material assumptions; and a statement that substantiating data will be made available to the prospect on request). Nevertheless, except as indicated below, franchisors should not be compelled to provide this information. Some cannot afford it. Others cannot (or believe they cannot) meet high standards for accuracy, relevance (geographic or otherwise) and completeness.

Some franchisors choose not to make "earnings claims" for a variety of reasons. They are costly to compile, often requiring the expensive time of lawyers and accountants. Such costs increase annually or more frequently because the disclosures often must be modified to reflect current information and material changes that may have taken place since the

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last compilation. Also, franchisors often have great difficulty causing their franchisees to report their operating results, annually, quarterly or more frequently. Moreover, often there is difficulty seeing to it that such information is received, evaluated, compiled and communicated to lawyers and accountants for inclusion in the offering circular each time it is revised. What's more, such information may not be accurate. Yet franchisors would be compelled (under the proposed bill) to furnish "earnings claim" information to prospects (who may sue them for fraud, deception and violation of the franchise sales laws if they don't succeed in the franchise business) which may be based on inaccurate or erroneous information received from franchisees. Accordingly, a mandatory earnings claim disclosure may cause some entrepreneurs to forego franchising altogether and others to raise the prices of their franchises.

Another shortcoming of this aspect of the bill is that it limits the sources of factual data available to franchisors in preparing the disclosure where no such limitation exists under current law. Only operating data from franchised or nonfranchised outlets of the franchisor operating under the mark to be licensed and offering the same products and services may be used. While the sources contained in the bill are good ones, franchisors should not be so limited nor should they be saddled with the risk associated with use of a potentially unlawful earnings claim because the sources of all such factual data may not strictly comply with the foregoing requirements. As far as permitted sources of factual data are concerned, the UFOC Guidelines (which require only that an earnings claim have a reasonable basis when made and that it be disclosed in the circular in full together with a description of its factual bases and underlying material assumptions) are superior to the bill, both for franchisors and their prospects.

For the foregoing reasons, the mandatory earnings claim disclosure portion of the bill should be replaced with an optional disclosure which is consistent with the UFOC Guidelines, except in two important respects. First, franchisors should be required to disclose important operating loss information for franchised outlets and company-owned outlets similar to the type to be offered to prospects if known (or with the exercise of reasonable diligence, discoverable) by the franchisor. While some franchisors choose not to furnish earnings claims for the reasons stated above, there are many others who don't do it because if they did prospects would see that their outlets are performing poorly. Consequently, they may have trouble selling their franchises. Prospective franchisees should receive this important information. Second, if a franchisor chooses to make an earnings claim, wherever possible, it should be required to disclose the number and percentage of franchised outlets in operation during the relevant period that actually performed as well or better. In situations where this disclosure is not possible, the franchisor should disclose the reasons why and should be required to make the disclosure when the impossibility no longer exists.

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(xii) a statement disclosing: (a) the names, addresses and telephone numbers of current franchisees; (b) the number of former franchisees of the franchisor for the last five fiscal years and the availability of an updated listing of information on such former franchisees (including name, last known address, location of unit, dates of ownership and reasons for leaving the franchise system); (c) for the prior ten year period the number of all prior owners of a specific franchise outlet to be resold (or if an outlet is not being resold, the number of prior franchisees who did business during the prior ten years in the same protected area or, if there is no such area, within the local market area in which the outlet will be located (and for this information a separate statement need be given only to prospective purchasers of such outlet or for a unit in such territory); and (d) whether there are any trade associations or like organizations of franchise owners which are organized to promote franchisee interests and if so, certain identifying information including whether they are independent of or affiliated with the franchisor.

Current disclosure law already requires that a substantial amount of statistical information on franchises of the franchisor (as of its fiscal year end) be furnished to prospects. This includes the number of franchises (effective franchise agreements) granted and of those, the number for which a business was operational, the number of terminations and nonrenewals during the last three fiscal years of the franchisor (and the reasons therefor) as well as the identification of franchisees who left the franchise system during the prior twelve month period. In light of current requirements, some of the disclosures called for by this section will furnish more useful information to prospects with little burden or risk to the franchisor while other requirements would impose an undue burden on franchisors with little corresponding benefit to prospective franchisees.

For example, the disclosure of information on franchisee trade associations would be helpful to prospects and would not unduly burden franchisors. Prospects who do a reasonably thorough presale investigation should learn of the associations anyway. It is not unreasonable or overly burdensome to require that franchisors disclose the existence of such associations and whether they are affiliated with or independent of the franchisor. Likewise, the requirement that franchisors disclose limited identifying information on their current (and most proximate) franchisees does not impose an obligation on them which exceeds current requirements.

Conversely, the proposals for disclosure of extensive information on former franchisees, their outlets and their market areas would present serious and costly compliance difficulties for franchisors with little countervailing benefit for prospects. It makes sense to give franchisees a reasonable amount of information on former franchisees so that they can do their due diligence. Therefore, it should not hurt modestly to expand the disclosure of such information now required under the UFOC Guidelines to cover a period greater than one year, to be phased in to include perhaps three years worth of information for each year after the law is passed. Nor should it create an undue burden to add the general location

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of the former franchisee. The goal should be to create a document that may be supplemented but that need not be changed constantly over time, except to delete "stale" information that need not be disclosed. It would be unduly burdensome and of little value, however, to make franchisors disclose old dates of ownership and reasons for termination (which may be disputed) since many prospects who take franchise investigation seriously will try to learn this information from former franchisees anyway. It should be sufficient to disclose information that will allow prospects to contact the former franchisees. And it would be even more burdensome to make franchisors compile lists of former franchisees (covering a ten year period) that operated in vague undefined market areas and to include dates of ownership, reasons for termination (which may be disputed or unknown by present franchisor management) and like information. This kind of historic information should be limited to the situation where a specific franchised outlet is being resold.

> (xiii) a balance sheet for the franchisor's most recent fiscal year, income statements and statements of changes in financial position (also known as statement of cash flows) for its three most recent fiscal years, prepared in accordance with generally accepted auditing standards and audited (with certain exceptions) by an independent licensed or certified public accountant including a separate, concise and conspicuous summary of the franchisor's sources of revenue for each year stated as a percentage of its total annual revenues attributable to each of the following categories: (a) preopening fees (e.g. initial franchise fees); (b) royalty payments; (c) preopening purchases by franchisees of equipment, inventory and supplies; (d) net rental income from franchisees for real estate leases or rentals of realty, fixtures or equipment; and (e) post-opening purchases by franchisees of equipment, inventory and supplies including payments to the franchisor by suppliers from whom franchisees are required to purchase their goods.

To the extent the bill would require franchisors to furnish prospects with financial statements, it substantially reflects current law with no additional burden for franchisors. Indeed, most state disclosure laws and the UFOC Guidelines also require that franchisors provide prospects with more current (though not necessarily audited) financial statements.

With certain exceptions, however, the additional disclosures suggested by this portion of the bill would impose a costly additional burden on franchisors in the preparation of audited financial statements with little added benefit to prospective franchisees. This is especially true for disclosure of revenues from franchisee payments to the franchisor (or its designees) for rent, lease payments and purchases of inventory, equipment and supplies (as well as rebate-type payments (or credits) to the franchisor by suppliers of franchisees designated by the franchisor) where much of this information should be disclosed under UFOC Item VIII (and in a more meaningful format) and under FFDCPA Section 4(a)(6). On the other hand, because most franchisors maintain the information for their own purposes, they should not find it overly difficult to disclose total revenue derived from initial franchise-type fees and roy-

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alty-type fees so long as such fees are clearly defined. Such information could appear as a line-item in (or a note to) the financial statements. And even if a brief summary is prepared by the auditor, the cost should be negligible since the auditor must do essentially the same work in the absence of furnishing the statement. Moreover, prospects should know this information so that they can determine the extent to which a franchisor is dependent on selling franchises to stay afloat as opposed to a healthier cash flow based on other revenue streams such as royalties, revenue from product sales and the like.

Finally, if it can be done efficiently, prospects would benefit greatly from disclosure of more detailed franchisor *expense* information such as the allocation of a franchisor's financial and human resources to training and servicing of franchisees as compared with resources allocated to franchise sales and marketing, accounting and collection of payments due from franchisees. If such a disclosure cannot be made without undue burden to franchisors, however, franchise prospects would benefit from inclusion in the circular of a cautionary statement reasonably calculated to come to their attention which would alert them to inquire about such resource allocations in their presale dealings with franchisors.

ENFORCEMENT BY THE FEDERAL TRADE COMMISSION

The FFDCPA would provide for enforcement by the FTC in a manner consistent with its powers under the Federal Trade Commission Act (15 U.S.C.§§45 *et. seq.*) ("FTCA") generally and the FTC Rule in particular. Any person who violates the proposed statute would be entitled to the same rights, privileges and immunities and subjected to the same penalties, jurisdiction and procedures as provided in the FTCA with the following exception. The three year statute of limitations for civil actions normally applicable to FTCA violations (FTCA Section 19(b), 15 U.S.C. Section 57b(d)) would be preempted by one allowing actions to be brought before the later of five years from the date of occurrence or three years from the date on which the violation was discovered or which the exercise of reasonable diligence should have been discovered.

Furthermore, if the UFOC Guidelines are amended by the North American Securities Administrators Association[6] (NASAA) or its successor, disclosures prepared in compliance with any such amendment would be presumed to comply with the FTC Rule, unless within 180

6. On July 22, 1992 NASAA issued proposed revisions to the UFOC for public comment. The proposal is designed to clarify the Uniform Franchise Offering Circular requirements through the use of "plain English" and extensive information tables. The public comment period closed on November 13, 1992. After extensive examination, it is the author's view that except for certain valid suggestions, the proposed revisions do not appear to better inform prospective franchisees of material facts regarding an offer of franchises, and therefore, are not worth the increased costs and exposure that will be realized by franchisors if they are required to comply with the suggested format. Simplicity is a worthy goal. The proposed changes are not noticeably simpler, however.

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days of formal notice by NASAA the FTC responds in writing that such amendments do not provide equal or greater protection to prospective franchisees than the FTC Rule.

The powers, duties, remedies and procedures to be given to the FTC under the bill are intended to be in addition to its powers, duties, remedies and procedures otherwise provided under law. In addition, the FTC would be empowered to make such rules as it deems necessary to implement the FFDCPA's provisions.

Actions by Private Persons

This is the most controversial part of the bill because it would provide people with valuable private remedies in the event of its violation *or* a violation of any FTC rule or order thereunder. While it is not expressly provided for, presumably this would include a claim for violation of the current FTC Rule as well.

In particular, anyone injured by a violation of the FFDCPA (or such rule or order) could sue the violator for damages caused by the violation, the costs of litigation, a reasonable attorney fee and equitable relief. Suit could be brought in federal district court irrespective of the amount in controversy or in any other court of competent jurisdiction before the later of five years from the date of occurrence or three years from the date on which the violation was discovered or with the exercise of reasonable diligence should have been discovered. It would not be necessary to seek relief first from the FTC. Suits in federal court for declaratory relief (and related injunctive relief in the event of threatened injury) also could be brought. And in a departure from traditional doctrine, in limited cases where the public interest would be served by halting a recurring or likely violation, temporary restraining orders and preliminary injunctions could be obtained pending trial without proof of special or irreparable damage. These rights would be in addition to and not in lieu of other rights or remedies available under federal and state law.

In light of the one-sided nature of franchise contracts in favor of franchisors, franchisees need a private right of action for losses suffered or threatened as a result of federal franchise sales law violations. Currently, no such right exists for claims of unfair methods of competition or unfair or deceptive acts or practices in trade or commerce under FTCA Section 5 even though the Federal Trade Commission called for Congress to provide one when it promulgated the FTC Rule in 1978.[7] After this rule became law, federal courts uniformly have denied private plaintiffs' claims for its violation on the ground that Congress has not seen fit to empower them.[8] Only the FTC may seek redress for these

7. *See* Statement of Basis and Purpose in support of FTC Franchise Disclosure Rule, 44 Fed. Reg. 49966, 49971 (1978).

8. *See e.g., Symes v. Bahama Joe's, Inc.*, (CCH) *Business Franchise Guide* ¶9192 (D. Mass. 1988) and *Chelson v. Oregonian Publishing Co.*, (CCH) *Business Franchise Guide*

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kinds of violations. Since the rule became effective in October 1979, however, there has been very little enforcement under the Reagan and Bush administrations.

As a result, those who suffered loss or abuse in the franchise sales process have been forced to assert whatever rights that may have been available to them under state law, including claims for common law fraud and for violation of state franchise disclosure laws and "little" FTC acts.[9]

Roughly two thirds of the states do not provide a private right of action to businesspersons for conduct which violates federal franchise sales law under "little" FTC acts.[10] Moreover, a similar majority have no franchise disclosure laws which provide private redress for losses occasioned by material misrepresentations and omissions in the offer and sale of franchises. Franchisees' chances for successful vindication of their rights when damaged by abuse in the franchise sales process should not depend on geography. All should be entitled to meaningful redress for the same wrongs, irrespective of what state laws apply. Accordingly, to fairly protect franchisees (and indirectly, their customers and those with whom they do business) and to help make uniform the law in this area, franchisees should have a private right of action to enforce the federal franchise sales laws against those who cause them losses. As a result, the worst abusers should disappear gradually from the marketplace while the reputable franchisors remain.

NO WAIVER OF RIGHTS OR LIABILITY

Franchisors would be forbidden from causing franchisees to waive or limit their rights under the proposed law by contract or otherwise. FFDCPA Section 7 would prohibit franchisors from requiring any term or condition in a franchise (or ancillary) agreement which directly or indirectly violates any provision of the proposed statute, any rule of the FTC thereunder or any provision of the FTC Rule. Also, it would forbid franchisors from requiring franchisees to assent to any disclaimer, waiver, integration clause or other provision which would purport to relieve any person from a duty or liability imposed by the Act, any rule of the FTC thereunder or any provision of the FTC Rule. Any contract term purporting to waive or restrict rights granted under the Act would

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¶7652 (D. Ore. 1981).

9. *See, e.g., Bailey Employment System, Inc. v. Hahn*, 655 F.2d 473 (2d Cir. 1981) and 545 F. Supp. 62 (D. Conn. 1982) *affirmed per curiam*, No. 82-7394 (2d Cir. 1983) (conduct constituting FTC Rule violations actionable under Connecticut little FTC Act) and *Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197 (N.J. Super., Law Div. 1986) (franchisor's FTC Rule violation a *per se* violation of New Jersey counterpart to FTC Act). *Contra, Symes v. Bahama Joe's, Inc., Ibid.* (FTC Rule violation not necessarily a violation of Massachusetts state little FTC Act, Chapter 93A).

10. *See* Stadfeld, "The FTC Franchise Disclosure Rule and Its Impact on Chapter 93A of the Massachusetts General Laws—A Source of Protection for Consumer Entrepreneurs," WESTERN NEW ENGLAND L. REV., Vol. 2, No. 4 at 681 (Spring 1980).

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be void and unenforceable.

These procedural rights are necessary to further the consumer protection policies underlying the bill. Franchisors should not be permitted to contract away their duty to comply with franchise sales laws. Such procedural protections already exist in most of the states (a minority) which have franchise registration and disclosure laws. To achieve uniformity, they should be extended nationwide so that if a dispute arises where a disgruntled franchisee has a legitimate claim for which redress is appropriate, the likelihood of success should not depend on geographic fortunes.[11]

Arbitration

Recognizing that contractual arbitration clauses have limited the availability of substantive and remedial rights to franchisees[12] than otherwise are available in litigation, FFDCPA Section 7(c) states that the proposed law would not limit the rights of franchisor and franchisee to agree to arbitration or other nonjudicial dispute resolution procedures *after* a dispute arises. It would prohibit use of such procedures, however, as a mandatory provision or condition in the franchise (or ancillary) agreement. Moreover, it would require that the standards and protections applied in any binding nonjudicial proceeding agreed to by the parties be not less than the requirements set forth in the bill. In addition, FFDCPA Section 8 calls for an amendment to the Federal Arbitration Act which would state, in substance, that whenever a franchise agreement provides for arbitration to resolve a dispute under the franchise agreement, each party will have the option at any time after the dispute arises, to accept arbitration as a means of settling the controversy, which acceptance must be in writing. The requirements of these sections would apply prospectively only to franchise contracts entered into, amended or renewed on or after the date of enactment.

Recognizing the constitutional imperative that existing contracts may not be eradicated by state action, the bill provides only for prospective application of these sections. That is, they would apply only to franchise

11. Franchisors argue that statistical evidence strongly demonstrates that the great majority (assume 90 percent for the sake of argument) of franchisees succeed and are reasonably content in their franchise relationships. Therefore, they claim, there is no need for new laws to protect franchisees. Their detractors contend that such statistical evidence is flawed and unreliable. None can dispute, however, that for each franchise that fails, the impact on the owner (frequently a small businessperson) can be catastrophic. Furthermore, even if one accepts the argument that such failures represent less than 10 percent of all franchise relationships and that (for the sake of argument) about half of those failures were caused by mismanagement or other fault of the franchisee, that still leaves a substantial number of small business disasters for which franchisors probably have a fair degree of culpability. In those cases, small business owners should have rights in order to make themselves whole. Such rights have rarely been found in franchise contracts or in the common law.

12. *See* H. Brown, *The Case Against Contractual Arbitration Covenants,* Franchise Law Journal, Vol. 11, No. 4 (Spring 1992) at 112.

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agreements entered into, amended or renewed after enactment. While there may be sound reasons for retroactive application of some remedial aspects of these sections, it is reasonable for them to be of prospective effect only. Franchisors are entitled to reasonable notice that their ability to dictate procedures for resolving disputes with franchisees may be restricted. The bill's prohibition on contracts requiring franchisee participation in nonjudicial proceedings to resolve serious disputes before they arise is consistent with its other remedial provisions and essential if the law's goals are to be realized. The proposed amendment to the Federal Arbitration Act is confusing, however. It would be clearer if it provided that after a dispute arises under a franchise agreement which provides for arbitration, each party to the agreement will have the option *not* to arbitrate.

PREEMPTION

The bill would preempt state law only to the extent that state law offers less protection to franchisees than provided in the Act and then, only to the extent of the inconsistency. The law is not intended to alter or relieve any franchisor from its obligations otherwise to comply with consistent state law nor is it intended to preclude any state from enacting laws or rules that afford a greater or broader range of protections to franchisees.

MISCELLANEOUS

The bill would require the FTC to conduct an ongoing study of the need to develop and implement additional laws to prevent evasions/violations of the Act or to strengthen disclosure of pertinent information to prospective franchisees. In doing so the FTC would be called on to consider the extent to which such additional provisions could be implemented under its rulemaking power. The FTC would be required to report to Congress within eighteen months of enactment of the bill on the implementation of the proposed statute as well as the study discussed above.

FEDERAL FAIR FRANCHISE PRACTICES ACT

The Fair Franchise Practices Act was proposed to add fairness and equity to franchise relationships by empowering franchisees with fundamental rights and concomitant remedies. Some believe this proposal to be long overdue.[13] Others complain vigorously that it constitutes regulatory overkill, and that if enacted, would cause many franchisors to with-

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13. Similar generic franchise protection legislation has not been given serious Congressional consideration since 1977 (H.R. 5016, 96th Congress, introduced by Rep. A. Mikva of Illinois).

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draw from markets ultimately to the detriment of small business. This article is not the place to debate all aspects of the bill. Its purpose is to report and comment briefly on the bill's highlights (and lowlights) and to discuss the significant issues involved.

The purposes underlying the FFPA are to establish greater equity and minimum standards of fair conduct in franchise relationships, to strengthen private remedies against wrongful conduct and to provide consumers the greater benefits which are anticipated to flow from equitable franchise relationships. In support, the bill proposes that certain findings of fact be codified, namely, that: (i) franchise relationships involve a joint enterprise between the parties in which each has a vested interest in the franchise business; (ii) many franchises reflect a profound imbalance of contractual power in favor of the franchisor and fail to give due regard to the legitimate business interests of the franchisee; (iii) franchisees may suffer substantial financial losses where a franchisor does not act in good faith or with due care; and (iv) traditional common law doctrines have not evolved sufficiently to protect franchisees adequately from fraudulent or unfair practices and significant contractual and procedural restrictions (*e.g.*, integration clauses and clauses on choice of law, venue, arbitration and limits on damages) have denied franchisees viable legal recourse against franchisors. There is substantial support for these findings.

Prohibted Conduct

The FFPA would prohibit a limited range of conduct. Certain prohibitions appear to be sound while others do not because they lack specificity or otherwise make illegal activity previously perceived as legitimate business conduct.

Good Cause for Termination

The bill would forbid franchise termination or cancellation without good cause. Most franchisors should not have a problem with this concept since most would not end such relationships without a sound business reason. Such reasons include, for example, the franchisee's failure to pay money due or to comply with the franchisor's quality standards in operating the franchised business. These should remain sufficient grounds for termination. Under the bill good cause is defined to include: (i) the franchisee's failure to comply with a *material* contract provision after notice and a reasonable opportunity to cure (thirty days or longer if necessary where cure is diligently pursued by the franchisee); (ii) the franchisee (without notice or opportunity to cure) abandons the business; is convicted of a crime that substantially impairs the franchisor's good will; repeatedly fails to comply with the same material contract term and enforcement is substantially the same for the other franchisees; or in operating the business the franchisee creates an imminent danger to the

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public health or safety; and (iii) the franchisor's voluntary or involuntary withdrawal from a marketing area if the franchisor compensates the franchisee for the shortened franchise term or agrees not to enforce a post-term noncompetition covenant except for prohibitions on use of trademarks or commercial symbols confusingly similar to the franchisor's.

While minor revision may be necessary, in substance, this prohibition is fair and reasonable. For example, there would have to be a thoughtful "material" contract provision definition which embraces all vital contract terms and excludes those of minimal significance. This is something that the parties should be able to work out. Properly revised, this portion of the bill would protect franchisees from harsh, oppressive and unfair conduct while reserving for franchisors necessary freedom to sever franchise relationships when reasonable and appropriate. It represents an improvement over existing statutes and the common law. Franchisors would not be limited to situations involving contract breaches by franchisees before termination could be achieved lawfully. It is troublesome, though, how franchisees would be compensated for a shortened franchise term. Once again, however, this minor detail can be resolved if there is support generally for the bulk of the bill. Moreover, the bill would be given prospective effect only so as not to impair existing contracts. And because most franchisors value their franchisees, they would not exercise the harsh termination remedy without a good reason. Indeed, such a provision may serve to remove undesirable franchisors from the industry and improve its image.

RESTRICTIONS ON POST-TERM NONCOMPETITION COVENANTS

The bill would forbid enforcement of post-term covenants (excluding probibitions on use of the franchisor's marks or confusingly similar symbols) which would preclude a franchisee from engaging in any business at any location (most significantly, the area where the franchisee's business was located) under most circumstances unless the franchisor offers to buy the assets of the franchised business for its fair market value as a going concern. The value would be determined by an impartial appraiser using a term of years for the business as long as the term of franchises the franchisor is then granting. Moreover, forgiveness of any debt owed by the franchisee to the franchisor would not be considered as part of the purchase.

This provision unwisely elevates the interests of the franchisee in the franchised business over those of the franchisor and the franchise system. Franchisors are not in the business of training competitors. Moreover, other franchisees in a franchise system have a vested interest in the integrity of the system. They have no desire to see competitors pop up after a legitimate termination or refusal to renew (for good cause) or after the franchise has expired consistent with the intentions of the par-

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ties. What's more, franchisees need a financially viable franchisor to succeed. To require such compensation or to permit competition in *all* cases of franchise severance may benefit the single franchisee but it would be detrimental to the franchise system (the franchisor and remaining franchisees) and its consumers if the bigger picture is taken into consideration. Further, if a legitimate debt is owed by the franchisee to the franchisor at the end of the relationship as is often the case, it would be unfair for that debt not to be considered in connection with a purchase contemplated by the bill. In light of the foregoing and the procedural problems likely to be created by the appraisal process, this portion of the proposed bill should be carefully rethought. Its application may be appropriate, however, in cases of unfair terminations and nonrenewals and in market withdrawals by the franchisor against the wishes of the franchisee.

Forbidding Prohibitions on Free Association by Franchisees and Other Actions

The bill would forbid franchisors from hindering or prohibiting franchisees from freely associating together for any lawful purpose including participation in or formation of a trade association. It also would prohibit franchisors from discriminating among franchisees (such as those who may choose to so associate) by imposing requirements not imposed on other similarly situated franchisees.

These proposals reflect current law in a minority of states.[14] Other states such as Washington prohibit franchisors from discriminating between similarly situated franchisees. Neither party would be disserved by this proposal.

The bill also would prohibit traditional fraud, deceit and deception as well as discrimination among franchisees on the basis of race, sex, religion, disability or national origin with certain exceptions, both before and during the franchise relationship. Other unspecified unlawful practices in the franchisor's enterprise or method of business would be forbidden. Some of these broad prohibitions raise the question of whether a franchisor is to be held to a higher standard than previously at common law or under other applicable statutes, and if so, to what standard. They may have a chilling effect on franchising and cause certain participants to refrain from entering markets that they otherwise may have entered. In light of the uncertainty and confusion which would result as well as the availability of other laws in such areas, these proposals (except those dealing with fraud, deceit and deception) appear to be unwise as drafted.

14. *See*, for example, Massachusetts G.L. c. 93B §10 (free association rights for automobile dealers).

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STANDARDS OF CONDUCT

The FFPA seeks to impose certain standards of conduct on franchisors including a duty of good faith, a duty of due care and a limited fiduciary duty.

GOOD FAITH

The bill provides that each franchise contract imposes on the parties a duty to act in good faith in its performance and enforcement. It is well recognized at common law that there exists an implied covenant of good faith and fair dealing in every commercial contract.[15] This includes franchise agreements. The FFPA would appear to transcend the common law, however, by codifying the following definition of good faith.

> This duty of good faith obligates a party to a franchise, in making a decision that directly affects the franchise or the business conducted under the franchise, to give fair regard for the interests of the other party or parties that are likely to be affected by the decision and to refrain from conduct that may injure or impair the right of the other party or parties to receive the reasonably anticipated benefits of the franchise.

Many franchisors will complain strenuously over this provision. They always will purport to act in good faith in dealings with their franchisees. In litigation or arbitration, however, they will seek maximum legal protection taking the position that they would be acting in good faith so long as they act consistent with the rights they have reserved under the contract, whether or not oppressive or unfair and whether or not conspicuously brought to the franchisee's attention before execution of the contract. Such conduct, they would contend, is consistent with good faith since it would be consistent with the expectations of the parties as reflected in the written agreement.[16]

On its face, this argument does not offend common law contract doctrine. It misses the point, however, when applied to modern franchise relationships. Rights reserved under these one-sided agreements should not be exercised to injure the franchisee or to impair fundamental rights granted to the franchisee. It is apparent that in many franchise relationships, particularly those where the franchisee is sought out by the franchisor and told that if s/he follows the system s/he will be treated fairly and reasonably, there is a need for a higher standard of good faith which goes beyond standard Uniform Commercial Code notions of hon-

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15. *See, e.g., Anthony's Pier Four, Inc. v. HBC Associates*, 411 Mass. 451 583 N.E.2d 806 (1991).

16. *See Carlock v. The Pillsbury Co.*, (CCH) *Business Franchise Guide* ¶9465 (D. Minn. 1989) (no violation of good faith covenant by franchisor's sale of ice cream in other distribution channels (grocery stores) exclusive of franchised Haagen-Dazs Ice Cream Shoppes where expressly permitted by contract to do so despite franchisee claims of franchisor's pre-franchise sale promises to the contrary).

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esty and commercial reasonableness between seasoned businesspersons. This good faith imperative would recognize the unique dynamics of the franchise relationship, including for example, the faith and trust routinely sought out by franchisors and willingly and hopefully given by franchisees at the start of these long-term relationships.

Conversely, while it is essential to have a good faith definition which requires one party to give "fair regard for the interests of the other party," the proposed definition goes too far by imposing liability on one party (primarily the franchisor) when that party does not "refrain from conduct that *may* impair or injure the right of the other party or parties to receive the reasonably anticipated benefits of the franchise." How are franchisors to know whether conduct once determined to be lawful violates this amorphous standard? Franchisors are faced often with policy decisions that may hurt one or more franchisees but which in the long run (or for the entire franchise system) may make good business sense. Thus, this aspect of the proposed codification of the duty of good faith may stifle entrepreneurship by causing franchisors to refrain from entering markets or taking risks which otherwise might be economically sound.

Accordingly, while the need for basic respect for the franchisee in the relationship deserves protection in some form because modern franchise contracts do not do the job, the proposed good faith standard falls short of its desired goal. It needs further analysis and refinement.

DUE CARE

One commentator once raised the question of whether franchisors owe their franchisees a "duty of competence".[17] This same concept may be found in the FFPA and would impose on franchisors a duty of due care. That is, in most circumstances, the franchisor must "exercise the skill and knowledge normally possessed by franchisors in good standing in the same or similar types of businesses." The bill goes on to provide a vague definition of such skill and knowledge, both in terms of expertise in the underlying business and in organizing a franchise system. It then provides that this requirement may not be waived by agreement or by conduct but that the franchisor may limit in writing the nature and scope of its skill and knowledge and of its undertaking with a prospective franchisee, so long as no inconsistent representation is made to the prospective franchisee.

There is no doubt that it would be worthwhile to eliminate incompetent franchisors from the marketplace. Nevertheless, the bill's proposal to accomplish this goal sets a standard which is too high. It would accomplish more harm than good. Justifiably, start-up franchisors may be scared away from considering franchising as a method of expansion if

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17. Robert Joseph, Seminar Materials for Twelfth Annual Forum, American Bar Association Forum Committee on Franchising, Toronto, Canada (1989).

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they are to be held to the standard of mature franchisors. This would produce an anticompetitive result, leaving existing franchisors free from new competitors. Many would not be able to hire the personnel or otherwise fund the start-up costs necessary to meet the standard. Entrepreneurial opportunity would be stifled by such a barrier to entering a market. Furthermore, who is to set the standard (for each business and for franchising within each such business) for the necessary level of skill and knowledge that constitutes "due care"? The franchise disclosure laws and the common law of negligence should be sufficient to protect prospective franchisees who may consider taking a risk on one with a great idea or product but who may not have the desirable experience, organization or capitalization to satisfy the proposed due care standard. In addition, in new businesses, there may not even be a level of skill or knowledge "possessed by franchisors in good standing in the same or similar types of businesses" for comparison purposes. This concept should be eliminated from the bill.

LIMITED FIDUCIARY DUTY

The bill proposes that franchisors be held to the standard of a fiduciary solely in situations when they are dealing with their franchisees' finances. That is, when they: (i) perform bookkeeping, collection, payroll or accounting services for franchisees; and (ii) administer advertising funds consisting of pooled mandatory contributions from franchisees. The bill states plainly that without limiting the ability of any court to identify other circumstances when a fiduciary duty may exist in a franchise relationship, it does not create or extend a fiduciary duty to other aspects of the relationship.[18]

This aspect of the bill has merit. It gives franchisees additional protection while doing little harm to responsible franchisors. Franchisors should be scrupulously honest in their handling of franchisee advertising contributions. Systemwide centralized advertising is one of the main reasons people join a franchise system, so that they can compete with the larger organizations. Franchisors should not (and most do not) be spending franchisees' hard-earned advertising dollars to promote the sale of additional franchises. Rather, the funds should be spent promoting the underlying product or service marketed by the franchise system. More-

18. In *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979) the Eighth Circuit Court of Appeals stated (but did not hold) that a fiduciary duty running from the franchisor to the franchisee is inherent in franchise relationships. This dicta has been criticized extensively. There are decisions, however, which indicate that the existence of a fiduciary relationship in the franchise context depends on the facts of each case. *See Devery Implement Co. v. J. I. Case Co.*, (CCH) *Business Franchise Guide* ¶9889 (10th Cir. 1991) (whether a fiduciary duty exists under Oklahoma law in a manufacturer-dealer relationship depends on the facts); and *Carter Equipment Co. v. John Deere Industrial Equipment Co.*, 681 F.2d 386 (5th Cir. 1988) (franchise contract may be evidence of a fiduciary relationship under Mississippi law).

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over, franchisors can live within this standard and still retain the right under their agreements to allocate a fair portion of their administrative overhead to the advertising fund for work reasonably and properly undertaken for its purposes. As in other fiduciary relationships, franchisees necessarily place their faith and trust in franchisors to spend advertising contributions loyally and honestly for their benefit and for the benefit of the entire franchise system.

Similarly, if a franchisor undertakes accounting or bookkeeping services for its franchisees, they necessarily rely on the franchisor to perform these services loyally, honestly and with the same level of expertise they would obtain had they engaged a third party professional to do the work. Where such professionals may be held to the standard of a fiduciary, there is no reason why franchisees should receive less protection when forced to accept such services from their franchisors. And this is particularly true in franchise relationships where the parties may have adversarial interests in the accounting/bookkeeping work to be done. Many franchisors do not provide these services. Most need not unless they choose to do so. It would be wise, however, for the bill to distinguish between negligent and intentional violations, saving any kind of punitive damage remedy for knowing or willful wrongful conduct.

Procedural Provisions

These provisions seek to strengthen the substance of the proposed law and to grant franchisees procedural rights which often are contracted away by them unwittingly at the inception of the relationship. These would prohibit franchisors from requiring franchisees to agree to contract terms which would: (i) violate the proposed law; (ii) relieve persons from liability under it; (iii) waive or restrict any right granted under it; or (iv) deprive franchisees of its benefits, benefits under other state laws or the ability to bring legal actions in a court in the state of the franchisee's principal place of business by designating the law of another jurisdiction as governing the franchise agreement or another venue where litigation or arbitration must be commenced against the franchisor.

Merger/Integration Clauses

The bill attacks standard merger and integration clauses which are uniformly contained in almost all franchise agreements. It states that:

> [E]vidence of violation of this Act or such state law shall not be excluded by virtue of an integration clause, any provision of a franchise agreement or an agreement ancillary or collateral to a franchise, the parol evidence rule, or any other rule of evidence purporting to exclude consideration of matters outside the franchise agreement.

This proposal is tremendously important in light of the overwhelming majority of court decisions where claims of fraud and misrepresentation

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in the offer and sale of a franchise go unaddressed on the ground that all presale conduct is not admissible and not to be considered because of the integration clause and the parol evidence rule.[19]

The change is necessary and appropriate if the bill's public policies are to be realized and rights to be derived from them are to have meaningful value. In the real world it cannot be denied that presale conduct, omissions and statements by franchisors are very important to franchisees in deciding whether to buy a franchise. Over the long term, franchisors would have to supervise their sales personnel better. They may have to implement procedures which: (i) call for extensive presale oral review of the contract terms with prospects; and (ii) accurately memorialize presale statements and actions of the parties. This may be the only solution to achieve a true "meeting of the minds" between the parties at inception, a necessary achievement if fairness and equity are to embrace these relationships thereafter. Boilerplate language (well-understood and relied upon by franchisors but not by franchisees) should be replaced by recorded agreements clearly understood and meaningfully intended by both parties. This may be costly, but it is a reasonable, fair and preferable alternative to allowing deception to continue with the concomitant losses visited upon defrauded franchisees and their customers. If franchise sellers are held accountable and franchise buyers are conspicuously informed of their contract rights (or the lack of rights) and a real meeting of the minds actually occurs, it is likely that greater honesty and fair dealing will return to the marketplace. The reputable participants would remain and the disreputable would fail.

PRIVATE RIGHT OF ACTION

The bill would authorize anyone injured by a violation to bring an action for damages, litigation costs and a reasonable attorney fee against the violator in any federal district court for a period up to five years after the date of the violation or three years following its discovery or the date it should have been discovered with the exercise of reasonable diligence. Injured persons as well as those threatened with injury by its violation would be empowered to sue for declaratory and injunctive relief. Preliminary injunctions would be available under the customary procedural rules with the exception that no special or irreparable damage need be shown by the party seeking such relief. This is not unreasonable because the alternative is for the franchisee to go out of business and hope for a damage recovery years later even where it may have demonstrated a likelihood of success on the merits of its claim.[20] No injunction would be

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19. Compare, however, *McEvoy Travel Bureau, Inc. v. Norton Company*, 408 Mass. 704, 563 N.E.2d 188 (1990) (defendant's statement that it did not intend to enforce contractual termination clause which was included only on advice of counsel could form basis for claims of fraud and violation of state "little" FTC Act notwithstanding such express termination rights and integration clause).

20. *See, e.g.*, *Semmes Motors, Inc. v. Ford Motor Co.*, 429 F.2d 1197 (2d cir. 1970).

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entered if no likelihood of success is shown. The bill points out that nothing in it is intended to deprive any person of the ability to settle a dispute through arbitration or other nonjudicial processes so long as the use of such procedures is not mandatory on any party.

Preemption

The bill would preempt state law only to the extent that state law offers less protection to franchisees than provided in the Act and then, only to the extent of the inconsistency. The law is not intended to alter or relieve any franchisor from its obligations otherwise to comply with consistent state law nor is it intended to preclude any state from enacting laws or rules that afford a greater or broader range of protections to franchisees.

Prospective Effect

As with the FFDCPA, the bill provides only for prospective application. That is, it is to apply only to franchise agreements entered into, amended, exchanged or renewed after its enactment. While there may be sound reasons for retroactive application of some remedial aspects of the bill, as a whole, it is more reasonable and fair for it to be of prospective effect only. This is especially true because it would create new substantive rights and obligations.

CONCLUSION

Franchising is too important to be governed by contracts of adhesion unilaterally drafted by franchisors and often offered to franchisees on a take-it-or-leave-it basis. Despite their necessary and historically important contributions to franchising, few franchisees have meaningful rights in their long-term relationships with franchisors. As one noted comedian put it, they "don't get no respect". Because they need such rights and because they make a comparatively huge investment (of time, capital and trust) in the relationship, uniform federal legislation with certain aspects of the FFDCPA and FFPA is needed to protect their interests.

The FFDCPA and FFPA contain some excellent proposals. As drafted, however, certain portions of the FFDCA constitute franchisor overkill because they place some unreasonably burdensome obligations and risks on franchisors without countervailing benefits accruing to prospects and franchisees. These inadequacies can and should be remedied, however, because franchisees and consumer entrepreneurs need protection and no other source is available to them. Similarly, as drafted, the FFPA goes too far by placing certain unwise, vague and far-reaching restrictions on franchisors. If either or both bills are enacted as written, they may have the undesired effect of increasing the cost of franchises and promoting franchisor withdrawals from certain markets and

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industries.

The House Small Business Committee should be commended for its efforts to further the interests of small businesses and their customers. Its work is not over, however, because the FFDCPA and FFPA need substantial refining before they can be pronounced fit for franchising.

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