

Minnesota Attorney General: Administrative Rules Proceedings

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Version 3
August 20, 2018

DEPARTMENT: Office of the Attorney General

STATE OF MINNESOTA

OFFICE MEMORANDUM

DATE: February 28, 1991

TO: PATRICIA L. PETERSON
Director of Registration
Department of Commerce

FROM: MARTHA J. CASSERLY
Special Assistant
Attorney General

PHONE: 296-6839

SUBJECT: In the Matter of the Adopted Rule Relating to Franchise Arbitration

The above-referenced rule has been approved as to its legality by the Attorney General on February 28, 1991.

Enclosed is your copy of the approved rule. This office has already filed two copies with the Secretary of State, who will forward one copy to the Revisor of Statutes. The fourth is being retained by this division of the Attorney General's Office for its records.

Also enclosed are any petitions, requests, submissions or comments along with any extra copies of documents which you submitted to the Attorney General.

Your next step is to arrange for publication of the Notice of Adoption in the State Register. In a day or two, you should receive from the Revisor's Office three copies of the notice of adoption of your rule. You should submit two copies of the Notice of Adoption to the State Register for publication. A permanent rule without a hearing does not become effective until five days after a notice of adoption is published in the State Register in accordance with Minn. Stat. § 14.27. An emergency rule becomes effective five working days after approval by the Attorney General; however, the agency must publish a notice in the State Register in accordance with Minn. Stat. § 14.34.

If you have any questions in this regard, please contact me.

MJC:sc

cc: Louis Hoffman
William Brown, Chief Judge
MaryAnn Hruby

Department of Commerce

Adopted Permanent Rules Relating to Franchise Arbitration

Rules as Adopted

2860.4400 UNFAIR AND INEQUITABLE PRACTICES.

All franchise contracts or agreements and any other device or practice of a franchisor, shall conform to the following provisions. It shall be unfair and inequitable for any person to:

[For text of items A to I, see M.R.]

J. require a franchisee to waive his or her rights to a jury trial or to waive rights to any procedure, forum, or remedies provided for by the laws of the jurisdiction, or to consent to liquidated damages, termination penalties, or judgment notes; provided that this part shall not bar an exclusive arbitration clause;

[For text of items K to M, see M.R.]

STATE OF MINNESOTA
DEPARTMENT OF STATE
FILED

APPROVED AS TO FORM AND LEGALITY

Feb 28 1991

HUBERT H. HUMPHREY, III
ATTORNEY GENERAL

BY M J Cassedy

SPECIAL ASSISTANT ATTORNEY GENERAL

STATE OF MINNESOTA
DEPARTMENT OF STATE
FILED

FEB 28 1991

Joan Anderson Growe

Secretary of State

4:20 P.M.

M

~~Rejected~~ Did not meet 30 days comment period

MJC

RULE REVIEW CHECKLIST

File No. 1797
DATE RECEIVED 2-14-91
REVIEW DATE 2-25-91
DUE DATE 2-28-91
(DIS)APPROVED 2-28-91 mjc
WITHDRAWN

Docket No. 05 0009 0126
ADOPTED W/O HEARING
EMERGENCY RULE
TO REVISOR ON 2-26
REVISOR (DIS)APPROVED 2-28-91
FILED W/SEC. OF STATE
RETURNED TO AGENCY

✓ Rule as adopted (4 copies)

✓ Notice to Solicit Outside Information/Opinion (if applicable)
November 13, 1990 Date published in State Register
Comments

Petition for Adoption of a Rule

~~Board's Authorizing Resolution~~
Date adopted

✓ Proposed Rule
✓ Revisor's Certificate

✓ Notice of Intent to Adopt Rule * missing see notes
45.023 80C.18 Statutory Authority
Small Business Statement
Expenditure of public money statement
not dated by signed Signature

✓ Statement of Need and Reasonableness (if applicable)
✓ Small Business Statement
Fees - § 16A.128

✓ Affidavit of Mailing Notice of Intent to Adopt Rule
December 13, 1990 Dated * 30/25 days before adoption
Notice attached indicates it is attached
Copy of rule or summary attached

✓ Publication in State Register
December 17, 1990 Date * 30/25 days before adoption

✓ 180-day deadline from:
✓ Effective date of law requiring rule (14.12) (both rules) amendments don't apply not mandatory
✓ end of comment period (§ 14.26) (rules without hearing)
effective date of statutory authority (§ 14.29) (emergency rules)

~~Resolution Adopting~~
Date adopted

✓ Findings of Fact, Conclusions & Order Adopting
January 4, 1991 Date * missing statement see notes

✓ Written Requests, Submissions or Comments

✓ Declaration of Attorney
Louis Hoffman Name of SAAG representing agency

~~Notice of Submission to Attorney General (if applicable)~~

SF-00006-05 (4/86)

DEPARTMENT : of COMMERCE

STATE OF MINNESOTA

Office Memorandum

DATE : February 25, 1991

TO : PATRICIA S. NOLTE
Legal Assistant
525 Park, Suite 500

FROM : PATRICIA L. PETERSON
Director of Registration

PHONE : 296-2284

SUBJECT : Proposed Permanent Rules Relating to Franchise Arbitration

Enclosed please find Findings of Fact, Conclusions and Order of Adoption in the above matter.

P.L.P.

Enclosure
/da

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed Rule Relating to Franchise Arbitration

FINDINGS OF FACT CONCLUSIONS & ORDER OF ADOPTION

Notice of the Commissioner's proposed adoption of the above-entitled rule without public hearing was published in the State Register on December 17, 1990. On December 13, 1990, the Department of Commerce sent copies of the Notice by United States mail to all persons on the list maintained by the agency pursuant to Minnesota Statutes, Section 14.14, Subdivision 1, paragraph (a) and 14.22. The Statement of Need and Reasonableness was prepared before the Notice of Intent to Adopt a Rule Without a Public Hearing was mailed to all persons on the rulemaking mailing list and published in the State Register and was available to the public.

All persons were given the opportunity to submit comments on the rule for thirty days after notice of proposed rulemaking. No requests for a public hearing were received by the agency within the thirty day comment period. No requests for notice of submission to the attorney general were received by the agency.

Based on the comments and evidence in the record before the agency, I find that the above-captioned rule is needed and reasonable.

NOW, THEREFORE, IT IS ORDERED that the rule identified as the Rule Relating to Franchise Arbitration is adopted this 19th day of February, 1991 pursuant to the authority vested in me by Minnesota Statutes, Section 80C.18.

BERT J. MCKASY
Commissioner of Commerce

Dated this 19th day of February 1991.

Reject not 30 days
only 17 days

45.023

The commissioner of commerce may adopt amend suspend, or repeal rules including emergency rules

80C.18

The commissioner may promulgate rules to carry out the provisions of sections 80C.01 to 80C.22, including rules and forms governing public offering statements, applications, financial statements . . .

Notice of Intent -

Missing E (11) A Statement that the proposed rule is ~~attached~~ attached to the notice or a summary of the rule. There is a statement in the last paragraph stating "those who wish to receive a copy of the rule should contact Patricia Peterson

Findings of Fact no statement that

Missing K (2) - Statement of Need was prepared prior to the Notice of Intent K (4) no statement of 30 days to comment

K (7) no statement if there were no requests for notice of submission of the rule to the Attorney General - Patricia Peterson did do an affadavit stating

that but it is not in the Findings

no 30 day comment period

December 17 - January 4 = 17 days

2-19-91

Talked to Pat Peterson told her Findings of Fact must be redone - she said January should have been written February told her missing info in Findings of Fact and Notice of Intent. Told her adopted rules were not initialed by the Revisor she said she would take care of this.

SF-00006-05 (4/86)

DEPARTMENT : of COMMERCE

STATE OF MINNESOTA

Office Memorandum

DATE : February 12, 1991

TO : ALAN GILBERT
Special Assistant Attorney General

FROM : PATRICIA L. PETERSON
Director of Registration

PHONE : 6-2284

SUBJECT : Franchise Rule

Enclosed are copies of the following materials regarding the above-captioned rule:

1. Notice of Intent to Solicit Outside Opinion as published in State Register (2010.0300 A).

2. Copy of the Proposed Rule with Revisor's Certificate (2010.033 D).

3. Notice of Intent to Adopt Rule Without Public Hearing (2010.0300 E).

4. Statement of Need and Reasonableness (2010.0300 F).

5. Affidavit of Mailing Notice of Intent to Adopt Rule Without Public Hearing (2010.0300 G).

6. Copy of Notice of Intent to Adopt Rule Without Public Hearing and Rule as published in the State Register (2010.0300 H).

7. Four copies of Rule as adopted (2010.0300 I).

8. Findings of Fact, Conclusion & Order Adopting Rule (2010.0300 K).

9. Written Comments, Submission & Requests on Rule (2010.0300 L).

P.L.P.

Attachment
/da

FILED
DEC 12 91
ATTORNEY GENERAL'S OFFICE
525 PARK TOWER
7TH PLACE AND MINNESOTA ST
ST. PAUL, MN 55101

Department of Commerce

Proposed Permanent Rules Relating to Franchise Arbitration

Rules as Proposed

2860.4400 UNFAIR AND INEQUITABLE PRACTICES.

All franchise contracts or agreements and any other device or practice of a franchisor, shall conform to the following provisions. It shall be unfair and inequitable for any person to:

[For text of items A to I, see M.R.]

J. require a franchisee to waive his or her rights to a jury trial or to waive rights to any procedure, forum, or remedies provided for by the laws of the jurisdiction, or to consent to liquidated damages, termination penalties, or judgment notes; provided, that ~~the franchise agreement may contain~~ this part shall not bar an exclusive arbitration clause ~~if the agreement allows the franchisee to opt out of the requirements of the clause~~;

[For text of items K to M, see M.R.]

Approved by Revisor _____

Office of the Revisor of Statutes

Administrative Rules

TITLE: Proposed Permanent Rules Relating to Franchise Arbitration

AGENCY: Department of Commerce

MINNESOTA RULES: Chapter 2860

The attached rules are approved for publication in the State Register

Paul M. Marinac
Assistant Deputy Revisor

Department of Commerce

Notice to Solicit Outside Opinion Regarding Proposed Amendments to Franchise Rules Including the Impact of the Rules on Small Business

NOTICE IS HEREBY GIVEN that the Department of Commerce is seeking information or opinions from persons outside the agency in preparing to amend current rules relating to arbitration and to make technical changes to various franchise rules. Promulgation of these rules is authorized by *Minnesota Statutes*, 45.023 and 80C.18.

Outside opinion is also being solicited as to how these rules will affect small businesses as defined by *Minnesota Statutes* 14.115, subdivision 1.

The Department of Commerce requests information and comments concerning the subject matter of these rules. Interested or affected persons or groups may submit statements of information or comment orally or in writing to:

Patricia L. Peterson
Director of Registration
Department of Commerce
133 East Seventh Street
St. Paul, Minnesota 55101
(612) 296-2284

Oral statements will be received during regular business hours over the telephone at (612) 296-2284.

All statements of information and comment shall be accepted until November 26, 1990. Any written material received by the Department of Commerce shall become part of the record in the event that the rules are promulgated.

Thomas H. Borman
Commissioner of Commerce

Minnesota Comprehensive Health Association

Notice of Meeting of the Ad Hoc Appeal Committee

NOTICE IS HEREBY GIVEN that a meeting of the Ad Hoc Appeal Committee of the Minnesota Comprehensive Health Association will be held at 1:30 p.m. on Tuesday, November 13, 1990, at the Yankee Place offices of Blue Cross and Blue Shield of Minnesota, 3500 Yankee Drive, Eagan, Minnesota.

Please note that the portion of the meeting to consider medical data relating to appeals is closed to the public.

For additional information, please call 456-8466.

Minnesota Comprehensive Health Association

Notice of Meeting of Public Policy and Legislative Committee

NOTICE IS HEREBY GIVEN that a meeting of the Minnesota Comprehensive Health Association Public Policy and Legislative Committee will be held on Friday, November 16th at 9:00 a.m., at Physicians Health Plan, 10th Floor Boardroom, 5601 Smetana Drive, Minnetonka, Minnesota.

For additional information, please call Lynn R. Gruber at 683-2150.

Minnesota Health Care Access Commission

Notice of Meeting of Health Care Access Commission

The next meeting of the Minnesota Health Care Access Commission will be Thursday and Friday, November 15 and 16, from 9:00 to 5:00 p.m. at the Riverwood Conference Center, 10990 95th Street N.E., Minneapolis. Please call the Health Care Access Commission, 297-5980, for further information.

All Commission meetings are open to the public.

DEPARTMENT: ATTORNEY GENERAL-Bremer Tower

State of Minnesota

Office Memorandum

DATE: February 14, 1991

TO: **PATRICIA S. NOLTE**
Legal Assistant
525 Park, Suite 500

FROM: **LOUIS HOFFMAN**
Special Assistant
Attorney General

PHONE: 6-9418

SUBJECT: **Proposed Permanent Rules Relating to Franchise Arbitration**

Enclosed please find the materials listed in the February 12, 1991 memorandum from Ms. Peterson to Mr. Gilbert in connection with the above-referenced rules. Also enclosed is my declaration of counsel.

Should you have any further questions with respect to this matter, please let me know.

LH:ew/.tb8
Enclosure(s)

cc: Patricia L. Peterson
Director of Registration
Department of Commerce

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed Adoption of Rules Relating to Franchises.

Notice of Intent to adopt Rules without a Public Hearing.

(1) Notice is hereby given that the Department of Commerce intends to adopt the above-entitled rules without a public hearing following the procedures set forth in the Administrative Procedures Act for adopted Rules without a public hearing in Minnesota Statutes, section 14.22-14.28. Authority for the adoption of these rules is contained in Minnesota Statutes, Section 45.023 and 80C.18.

(2) All persons have 30 days to submit comments in support of or in opposition to the proposed rule or any part or subpart of the rule. Comment is encouraged. (3) Each comment should identify the portion of the proposed rule addressed, the reason for the comment, and any change proposed. (8) The proposed rules may be modified if the modifications are supported by the data and views submitted to the Department and do not result in a substantial change.

Any person may make a written request for public hearing within the 30 days comment period. (4) If 25 or more persons submit a written request for a public hearing within the 30 day comment period, a public hearing will be held unless a sufficient number withdraw their request in writing. (6) Any person requesting a hearing should state his or her name and address, and is encouraged to identify the portion of the proposed rule addressed, the reason for the request, and any change proposed. (7) If a public hearing is required, the Department will proceed pursuant to Minnesota Statutes, sections 14.13 to 14.20.

(5) Persons who wish to submit comments or a written request for a public hearing should submit them to:

Patricia L. Peterson
Director of Registration
Department of Commerce
133 East Seventh Street
St. Paul, Minnesota 55101
(612) 296-2284

(12) A Statement of Need and Reasonableness that describes the need for and reasonableness of each provision of the proposed rule and identifies the data and information relied upon to support the proposed rules has been prepared and is available upon request from Patricia Peterson.

(14) Pursuant to Minnesota Statutes Section 14.155, subdivision 2, the impact on small business has been considered in the promulgation of the rules. Anyone wishing to present evidence or argument as to the rules' effect on small business may do so. The Department's position regarding the impact of the rules on small business is set forth in the Statement of Need and Reasonableness.

(9) If no hearing is required, upon adoption of the rule, the rule and the required supporting documents will be submitted to the Attorney General for review as to legality and form to the extent the form relates to legality. Any person may request notification of the date of submission to the Attorney General. Persons who wish to be advised of the submission of this material to the Attorney General, or who wish to receive a copy of the adopted rule, must submit the written request to Patricia Peterson.

Thomas H. Borman

THOMAS H. BORMAN
Commissioner of Commerce

Secretary of State
8210.0200; .9915 (proposed) 1011

Water & Soil Resources Board
8405.0100-.0230 (adopted) 1312

Transportation Department
8810.8000; .8100; .8110; .8200; .8300; .8400; .8500 (adopted) 963
8820.0100; .0600; .0700; .0800; .1000; .1400; .1500; .1800; .1900; .2000; .2100; .2300; .2400; .2500; .2700; .2800; .2900; .3100; .3300; .3400; .9910; .9925; .9930; .9935; .9940; .9945; .9950; .9955; .9960; .9965; .9970 (proposed) 1354
8820.9911-.9910 (proposed repealer) 1354

Waste Management Office
9210.0100; .0110; .0120; .0130; .0131; .0140; .0150; .0160; .0170; .0180; .0400; .0410; .0420; .0425; .0435; .0440; .0450; .0460; .0500; .0510; .0520; .0530; .0540; .0550; .0560; .0570 (adopted) 839
9210.0100 s.2,3; .0120 s.1-4; .0160 s.3; .0400 s.2,12; .0420 s.4,5; .0430; .0440 s.3,4; .0450 s.1 (repealed) 839
9210.0600-.0645 (adopted) 964
9210.0700-.0770 (adopted) 1017
9210.1000; .1010; .1020; .1030; .1040; .1050; .1060 (proposed) 1356

Human Services Department
9505.0255 (adopted) 910
9505.0290; .0295; .0385; .0386; .0390; .0391 .0392; .0410; .0411; .0412 (proposed) 1398
9505.0290 s.12,13,14,15 (proposed repealer) 1398
9505.2395; .2440; .2445; .2455; .2465; .2490 (proposed withdrawn) 1017
9505.2445 s.2 (proposed repealer withdrawn) 1017
9530.6655 (proposed withdrawn) 1366
9575.1500 (proposed) 1046

Proposed Rules

Pursuant to Minn. Stat. §§ 14.22, an agency may propose to adopt, amend, suspend or repeal rules without first holding a public hearing, as long as the agency determines that the rules will be noncontroversial in nature. The agency must first publish a notice of intent to adopt rules without a public hearing, together with the proposed rules, in the *State Register*. The notice must advise the public:

1. that they have 30 days in which to submit comment on the proposed rules;
2. that no public hearing will be held unless 25 or more persons make a written request for a hearing within the 30-day comment period;
3. of the manner in which persons shall request a hearing on the proposed rules; and
4. that the rule may be modified if the modifications are supported by the data and views submitted.

If, during the 30-day comment period, 25 or more persons submit to the agency a written request for a hearing of the proposed rules, the agency must proceed under the provisions of §§ 14.14-14.20, which state that if an agency decides to hold a public hearing, it must publish a notice of intent in the *State Register*.

Pursuant to Minn. Stat. §§ 14.29 and 14.30, agencies may propose emergency rules under certain circumstances. Proposed emergency rules are published in the *State Register* and, for at least 25 days thereafter, interested persons may submit data and views in writing to the proposing agency.

Department of Commerce

Proposed Permanent Rules Relating to Franchise Arbitration

Notice of Intent to Adopt Rules Without a Public Hearing

NOTICE IS HEREBY GIVEN that the Department of Commerce intends to adopt the above-entitled rules without a public hearing following the procedures set forth in the Administrative Procedures Act for adopted Rules without a public hearing in *Minnesota Statutes*, section 14.22-14.28. Authority for the adoption of these rules is contained in *Minnesota Statutes*, Section 45.023 and 80C.18.

All persons have 30 days to submit comments in support of or in opposition to the proposed rule or any part or subpart of the rule. Comment is encouraged. Each comment should identify the portion of the proposed rule addressed, the reason for the comment, and any change proposed. The proposed rules may be modified if the modifications are supported by the data and views submitted to the Department and do not result in a substantial change.

Any person may make a written request for public hearing within the 30 days comment period. If 25 or more persons submit a written request for a public hearing within the 30 day comment period, a public hearing will be held unless a sufficient number withdraw their request in writing. Any person requesting a hearing should state his or her name and address, and is encouraged to identify the portion of the proposed rule addressed, the reason for the request, and any change proposed. If a public hearing is required, the Department will proceed pursuant to *Minnesota Statutes*, sections 14.13 to 14.20.

Persons who wish to submit comments or a written request for a public hearing should submit them to:

Patricia L. Peterson
Director of Registration
Department of Commerce
133 East Seventh Street
St. Paul, Minnesota 55101
(612) 296-2284

A Statement of Need and Reasonableness that describes the need for and reasonableness of each provision of the proposed rule and identifies the data and information relied upon to support the proposed rules has been prepared and is available upon request from Patricia Peterson.

Pursuant to *Minnesota Statutes* Section 14.155, subdivision 2, the impact on small business has been considered in the promulgation of the rules. Anyone wishing to present evidence or argument as to the rules' effect on small business may do so. The Department's position regarding the impact of the rules on small business is set forth in the Statement of Need and Reasonableness.

If no hearing is required, upon adoption of the rule, the rule and the required supporting documents will be submitted to the Attorney General for review as to legality and form to the extent the form relates to legality. Any person may request notification of the date of submission to the Attorney General. Persons who wish to be advised of the submission of this material to the Attorney General, or who wish to receive a copy of the adopted rule, must submit the written request to Patricia Peterson.

Thomas H. Borman
Commissioner of Commerce

Rules as Proposed

2860.4400 UNFAIR AND INEQUITABLE PRACTICES.

All franchise contracts or agreements and any other device or practice of a franchisor, shall conform to the following provisions. It shall be unfair and inequitable for any person to:

[For text of items A to I, see M.R.]

J. require a franchisee to waive his or her rights to a jury trial or to waive rights to any procedure, forum, or remedies provided for by the laws of the jurisdiction, or to consent to liquidated damages, termination penalties, or judgment notes; provided~~,~~ that ~~the franchise agreement may contain~~ this part shall not bar an exclusive arbitration clause ~~if the agreement allows the franchisee to opt out of the requirements of the clause~~;

[For text of items K to M, see M.R.]

Minnesota Housing Finance Agency

Proposed Permanent Rules Relating to Mortgage Revenue Bonds for the Purchase of New Housing

Notice of Intent to Adopt a Rule Without a Public Hearing

NOTICE IS HEREBY GIVEN that the Minnesota Housing Finance Agency intends to adopt the above-entitled rule without a public hearing following the procedures set forth in the Administrative Procedure Act for adopting rules without a public hearing in *Minnesota Statutes* sections 14.22 to 14.28. The statutory authority to adopt the rule is *Minnesota Statutes* 462A.06, Subd. 4 and 11.

KEY: PROPOSED RULES SECTION — Underlining indicates additions to existing rule language. ~~Strike outs~~ indicate deletions from existing rule language. If a proposed rule is totally new, it is designated "all new material." **ADOPTED RULES SECTION** — Underlining indicates additions to proposed rule language. ~~Strike outs~~ indicate deletions from proposed rule language.

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

IN THE MATTER OF THE PROPOSED AMENDMENTS TO FRANCHISE RULES

STATEMENT OF NEED AND REASONABLENESS

STATEMENT OF AUTHORITY

Minnesota Statements, Section 80C.18, subdivision 1 provides that:

> Subdivision 1. The Commissioner may promulgate rules to carry out the provisions of sections 80C.01 to 80C.22, including rules and forms governing public offering statements, applications, financial statements and annual reports, and defining any terms, whether or not used in sections 80C.01 to 80C.22, insofar as the definitions are not inconsistent with sections 80C.21 to 80C.22.

Additional rulemaking authority provided in Minnesota Statutes Section 45.023 authorizes the Commissioner to "adopt, amend, suspend, or repeal rules ... whenever necessary or proper in discharging the Commissioner's official responsibilities."

The Commissioner finds the proposed rules to be necessary and consistent with the purposes fairly intended by the policies and provisions of Chapter 45 and 80C.

Rule Part 2860.4400 J.

Minn. Rule Part 2860.4400 J prohibits mandatory arbitration. The rule provides that the franchise agreement may contain an arbitration clause only "if the agreement allows the franchisee to opt out of the requirements of the clause."

Representatives of the franchise industry have argued that the language of Minn. Rule Part 2860.4400 J is an unconstitutional restriction of the rights of parties to look to arbitration for dispute resolution. They argue that Section 2 of the Federal Arbitration Act preempts Minnesota's Arbitration rule.

The Federal Arbitration Act provides:

> A written provision in any maritime transaction or a contract evidencing a transaction involving Commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or

> any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Recent Supreme Court and lower federal court decisions have held that the FAA exists to address the traditional hostility of courts toward arbitration and that Congress through the FAA has preempted the state regulation of arbitration. See Southland Corp. v. Keating, 465 U.S. 1, 104 S.Ct. 852, (1984); Securities Industry Association v. Connolly, 703 F. Supp. 148 (D. Mass. 1988). aff'd., 883 F. 2d 1114 (1st Cir. 1989)., Saturn Distribution Corporation v. Williams 905 F. 2d 719 (4th Cir. 1990); Seymour v. Gloria Jean's Coffee Bean Franchising Corp., (D. Minn. March 14, 1990). Although there is no court challenge to the current rule, the Commissioner finds that it is reasonable at this time to defer to this line of cases.

Small Business Considerations

Arbitration is generally cheaper than judicial resolution of disputes and this is clearly an advantage for a small business whether that business is a franchisor or franchisee.

Since the rule does not involve compliance or reporting requirements schedules or deadlines or performance standards, necessary to discuss Minn. Stat. § 14.115, subdvision 2(a)-(e) is inapplicable to the proposed rule.

The Notice of Intent to Solicit Comment contained a statement that the rule may have an impact on small business.

In the Matter of the Proposed Rules
Relating to Franchise Arbitration

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF
MAILING

Dolores Anitzberger, being first duly sworn, deposes and says:

I hereby certify that the list of persons, associations, and other interested groups who have requested, pursuant to Minnesota Statutes, section 14.14, subd. 1a, that their names be placed on file with and maintained by the Department of Commerce for the purpose of receiving notice of the proposed adoption of rules was accurate and complete as of 12:00 p.m. the 13th day of December 1990.

That on the 13th day of December 1990, at the City of St. Paul County of Ramsey, State of Minnesota, the attached Notice of Intent to Adopt Rules Without a Public Hearing was served by depositing in the State of Minnesota Central Mail System for United States mailing as said City of St. Paul, a copy properly prepared with first-class postage prepaid, on all persons and associations who have requested that their names be placed on file with the Minnesota Department of Commerce for the purpose of receiving notice of the proposed adoption of rules by the department.

Dolores Anitzberger

Dolores Anitzberger

Subscribed and sworn to before me
this 29th day of January, 1991.

Cynthia L. Claason

Notary Public

CYNTHIA L. CLAASON
NOTARY PUBLIC-MINNESOTA
RAMSEY COUNTY
MY COMMISSION EXPIRES FEBRUARY 11, 1992

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed Rule Relating to Franchise Arbitration

FINDINGS OF FACT CONCLUSIONS & ORDER OF ADOPTION

(1) Notice of the Commissioner's proposed adoption of the above-entitled rule without public hearing was published in the State Register on December 17, 1990. On December 13, 1990, the Department of Commerce sent copies of the Notice by United States mail to all persons on the list maintained by the agency pursuant to Minnesota Statutes, Section 14.14, Subdivision 1, paragraph (a) and 14.22.

(4) All persons were given the opportunity to submit comments on the rule for thirty days after notice of proposed rulemaking. (5) No requests for a public hearing were received by the agency within the thirty day comment period.

Based on the comments and evidence in the record before the agency, I find that the above-captioned rule is needed (8) and reasonable.

NOW, THEREFORE, IT IS ORDERED that the rule identified as the Rule Relating to Franchise Arbitration is adopted this 4th day of January, 1991 pursuant to the authority vested in me by Minnesota Statutes, Section 80C.18. (9)

BERT J. MCKASY
Commissioner of Commerce

Dated this 4th day of January 1991.

LAURESS V. ACKMAN
GERALD E. MAGNUSON
EDWARD M. GLENNON
MELVIN I. ORENSTEIN
ROBERT J. SHERAN
ISRAEL E. KRAWETZ
EUGENE KEATING
JAMES P. MARTINEAU
RICHARD J. FITZGERALD
JOHN A. FORREST
WILLIAM E. FOX
JOHN J. CONNELLY
JERROLD F. BERGFALK
DAVID M. LEBEDOFF
JOHN H. STROTHMAN
DAVID G. NEWHALL
KURTIS A. GREENLEY
ROBERT V. ATMORE
PATRICK DELANEY
RONALD G. VANTINE
JOHN B. WINSTON
LAURANCE R. WALDOCH
THOMAS H. GARRETT III
DARYLE L. UPHOFF
DAVID J. DAVENPORT
MARK R. JOHNSON

RICHARD A. PRIMUTH
R. WALTER BACHMAN
THOMAS L. FABEL
JEFFREY R. SCHMIDT
TIMOTHY H. BUTLER
ROBERT G. MITCHELL, JR.
J. MICHAEL DADY
J. KEVIN COSTLEY
ROBERT J. HARTMAN
JOSEPH G. KOHLER
RICHARD D. McNEIL
DONALD C. SWENSON
BRUCE A. BONJOUR
JAMES P. McCARTHY
STEVEN J. JOHNSON
RICHARD IHRIG
CAROL T. RIEGER
RODERICK I. MACKENZIE
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THOMAS G. LOVETT IV
THOMAS E. GLENNON
JOHN R. HOUSTON
DENNIS M. O'MALLEY
EDWARD J. WEGERSON

LINDQUIST & VENNUM

4200 IDS CENTER
MINNEAPOLIS, MINNESOTA 55402-2205
TELEPHONE (612) 371-3211

FAX: (612) 371-3207
CABLE: LINLAW MINNEAPOLIS

WAYZATA OFFICE
740 EAST LAKE STREET
WAYZATA, MINNESOTA 55391

WRITER'S DIRECT DIAL NUMBER

(612) 371-3233

DANIEL J. SHERAN
DAVID A. ALLGEYER
TERRENCE J. FLEMING
ROLF ENGH
RICHARD T. OSTLUND
DEBORAH M. REGAN
MARTIN R. ROSENBAUM
ELINOR C. ROSENSTEIN
ROSANNE H. WIRTH
DEBRA K. PAGE
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ROBERT E. TUNHEIM
ANSIS V. VIKSNINS
LAURA L. DALY

OF COUNSEL
LEONARD E. LINDQUIST
NORMAN L. NEWHALL

RETIRED
THOMAS VENNUM

January 15, 1991

VIA FACSIMILE AND U.S. MAIL

Ms. Patricia L. Peterson
Director of Registration
Department of Commerce
133 East Seventh Street
St. Paul, MN 55101

State of Minnesota
JAN 16 1991
Dept. of Commerce

Dear Ms. Peterson:

The following comment relates to Proposed Rules Relating to Franchise Arbitration, 2860.4400 UNFAIR AND INEQUITABLE PRACTICES, published in the State Register on Monday, December 17, 1990.

We represent a large number of franchisees in their disputes with franchisors. We oppose adoption of Proposed Rule 2860.4400 because it effectively permits franchisors to require franchisees to forfeit, prospectively, all resort to judicial process in the event of a subsequent dispute. If enacted, this provision will further erode the rights of franchisees, who are already at a significant disadvantage due to their relative lack of bargaining power.

The existing Rule, which we support, allows a franchisor to insert an exclusive arbitration clause in its written franchise agreement if the same agreement also includes a provision allowing a franchisee to "opt out" of the arbitration requirement in the event that a dispute later arises and the franchisee chooses to pursue a claim in a legal, rather than arbitration, proceeding. Proposed Rule 2860.4400 removes that "opt out" provision requirement and expressly allows franchisors to insert exclusive arbitration clauses in their franchise agreements.

We believe that the protection afforded franchisees under the current Rule is necessary and warranted. In our experience, franchisors have often imposed these exclusive arbitration provisions on inexperienced franchisees in the form of "boilerplate" components of form franchise agreements which franchisees have no opportunity to negotiate or alter. As the attached Report of the U.S. House Committee on Small Business indicates, the franchisor's "[a]dvantages of financial strength,

access to information and to legal advice create a gross disparity of bargaining power in favor of the franchisor that results in one-sided agreements that are offered, and generally accepted, on a take-it-or-leave-it basis." STAFF OF SENATE ON SMALL BUSINESS, 101ST CONG., 2D SESS., FRANCHISING IN THE U.S. ECONOMY: PROSPECTS AND PROBLEMS (Comm. Print 101-04) at 49.

The above House Committee Report succinctly summarizes our concerns with respect to giving franchisors, as Proposed Rule 2860.4400 does, this additional means of inhibiting franchisees' exercise of legal rights:

> [A] device that has become the focus of increasing controversy involves contractual provisions requiring arbitration of all issues arising under a franchise agreement. Arbitration of franchising disputes has increased nearly five fold since 1981, according to the American Arbitration Association, due largely to increasing use of out-of-court resolution requirements in franchise contracts. Franchisors tend to view arbitration not only as faster and less expensive than court actions in resolving disputes, but also as a means of avoiding possible litigated recovery by franchisees, particularly where there is a possibility of multiple damages and large fee allowances. Arbitration also permits less public scrutiny of internal disputes that could be potentially damaging to the sale of new franchises.
>
> Where properly structured with impartial arbitrators, an arbitration proceeding can provide timely and effective resolution of many issues arising within a franchise relationship. But arbitration may be inappropriate, and even abusive, when required for all disputes between parties in a franchise, especially those involving terminations and renewals. Some franchisors have also sought to incorporate additional requirements in franchise agreements that are intended to weaken the arbitration process or discourage its use by franchisees. These include restricting the use of qualified arbitrators, requiring arbitration at the franchisor's home office, precluding access to all provable direct or consequential damages and/or punitive damages, and requiring payment of arbitration fees that grossly exceed actual costs or comparable costs of litigation. Requiring franchisees to agree in advance to arbitration of all matters, or to accept arbitration with numerous restrictions, has been

described as "tantamount to a contractual forfeiture of resort to all judicial process."

Id. at 63, emphasis added.

For all the foregoing reasons, we urge that the safeguards provided to franchisees by Current Rule 2860.4400 be left intact, and that the proposed modification to Rule 2860.4400 not be adopted.

Very truly yours,

LINDQUIST & VENNUM

J. Michael Daly, Esq.

Joseph A. Thomson, Esq.

Mary Ellen Alden, Esq.

MEA/dk
Enclosure

cc: Joseph A. Thomson, Esq.

[COMMITTEE PRINT 101-4]

FRANCHISING IN THE U.S. ECONOMY: PROSPECTS AND PROBLEMS

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

101st Congress, Second Session



AUGUST 1990

Printed for the use of the Committee on Small Business

This report has not been officially adopted by the Committee on Small Business and, therefore, may not necessarily reflect the views of its members

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U.S. GOVERNMENT PRINTING OFFICE
33-406 WASHINGTON : 1990

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LETTER OF TRANSMITTAL

August 13, 1990

To All Members, Committee on Small Business:

I am pleased to transmit herewith a staff study entitled "Franchising in the U.S. Economy: Prospects and Problems," prepared at my request by Dean M. Sagar, professional staff member with the Committee.

Business franchising has become a significant force in our nation's economy and a major influence in small business formation. Franchise businesses currently employ more than 7.2 million workers and account for an estimated $600 billion in annual sales of goods and services. The combined sales of franchise businesses now account for more than one-third of all U.S. retail sales and could exceed half of all sales by the end of the decade.

Despite its growing significance, there is a surprising lack of comprehensive and accurate information concerning all aspects of franchising nationally. There has also been relatively little attention given by Congress to a number of serious legal and regulatory issues that remain the focus of controversy and debate in state capitals across the nation.

This report provides Congress with its first comprehensive assessment of franchising in nearly two decades. It is intended to encourage discussion of key issues and problems in franchising and provide background information for Committee Members.

JOHN J. LaFALCE, *Chairman.*

C O N T E N T S

		Page
I.	Franchising in the U.S. Economy	1
	A. General	1
	B. Types of Franchise Arrangements	2
	C. History and Development	5
	D. Legal and Regulatory Influences	8
	E. Franchising in the 1980s	11
	F. Franchise Data and Future Growth	14
	G. International Franchising	16
II.	Regulation of Franchise Sales and Practices	21
	A. General	21
	B. The FTC Franchise Disclosure Rule	23
	C. State Regulatory Activity	27
	D. The Problem of Earnings Claims	32
	F. The FTC and Preemption of State Law	39
III.	Issues of Franchise Relations	49
	A. General	49
	B. State Franchise Fairness Laws	50
	C. Principles of Good Faith and Fair Dealing	54
	D. Franchisee Right of Action	58
	E. Contractual Limitations on Due Process	62
	F. Franchise Terminations, Renewals, and Transfers	65
	G. Seeking Balance in Regulatory Policy	70
IV.	Conclusion	74
	Appendices	77
	A. Franchise Growth 1969-1986	77
	B. Growth in Franchise Sales 1969-1986	78
	C. Franchise Growth Projections 1987-1990	79

I. Franchising In The U.S. Economy

A. General

Franchising has been called the most dynamic business arrangement since the emergence of the corporation a century ago. It is heralded as a "dominating force" in the distribution of goods and services and the "wave of the future" for the U.S. marketplace. By the year 2000, according to Time magazine, franchising will be the "primary method of doing business" in America.

For all the superlatives used to describe it, franchising remains a relatively obscure concept to most Americans. The tendency is to view franchising in extremes--either as an industry or economic sector in itself or as a process associated with a specific type of business, such as fast-food restaurants. The reality is somewhere in between. Franchising is something of an umbrella concept covering a wide variety of business arrangements and activities. Its strengths are its adaptability to an ever expanding array of industries, markets, and products and its responsiveness to economic developments and consumer tastes.

Franchising is essentially a method of distributing goods and services. From the legal standpoint, it is a contractual method for marketing and distributing the goods and services of a company (the franchisor) through a dedicated or restricted network of distributors (franchisees). Under the terms of the franchise contract, a franchisor grants the right and license to franchisees to market a product or service, or both, using the trademark and/or the business system developed by the franchisor. The contract imposes obligations on both parties: the franchisor must provide the product, a proven marketing plan or business format, management and marketing support and training; the franchisee brings financing, management skills, and a determination to own and operate a successful business.

If properly developed and executed, the franchise arrangement provides significant advantages for everyone involved. For the small or growing company with a successful product or method of

operation, franchising presents a systematic and cost-effective strategy for achieving rapid expansion of a marketing system with a minimum of direct involvement and financial investment. For prospective franchisees, it represents an opportunity to own and operate a business involving a tested product or business format with a minimum of financial risk. And for potential consumers, franchising provides a way to purchase known goods and services in a reliable and predictable manner.

Minimizing the risk of starting a new business through association with a franchisor is perhaps the most significant characteristic of a franchise relationship. A franchisee benefits from public awareness of the franchisor's trademark and products and is helped to avoid costly operating and marketing mistakes through training and continuing supervision and assistance. Commensurate with this increased potential for success, however, is a loss of independence resulting from the franchisee's contractual dependence upon the franchisor's ability to promote public recognition of products and services, to maintain uniform quality standards and to provide needed training and support. It is this loss of independence that distinguishes franchisees from other independent businessmen and provides the basis for most problems arising within franchising arrangements.

B. Types of Franchise Arrangements

Franchising encompasses a variety of business arrangements which fall generally within two categories: "product and trade name" franchises and "business format" franchises. Product and trade name franchises include arrangements in which franchisees are granted the right to distribute a manufacturer's products within a specified territory or at a specific location, generally with the use of the manufacturer's identifying name or trademark.

Examples of product/trade name franchises include automobile dealerships, gasoline service stations, soft-drink bottlers, and farm equipment dealers. Until the mid-1970s, gasoline stations epitomized the typical business franchise. In 1972 the 181,167 gasoline franchises accounted for 80 percent of all gasoline stations, 84 percent of all product franchises and nearly half (48.6 percent) of all franchise businesses. The oil shocks of the 1970s, together with significant changes within the oil industry in general, have reduced the number of gasoline franchises by half.[1] The 91,840 gasoline franchises operating in 1988 still accounted for 82 percent of all gasoline stations and 76 percent of all product franchises, but their share of total franchising declined to 22 percent. And while product/trade name franchises continue to account for two-thirds of all franchise sales, they now represent less than 30 percent of all franchise businesses.[2]

A newer development, the business format franchise, generally incorporates the licensing of a trademark with the conveyance to franchisees of a business format, or an entire system for conducting a business. The franchisee is required to comply with the franchisor's guidelines governing the operation of the business and the appearance of the business location. The quality of the products or services provided by franchisees also is typically controlled by the franchisor. The most common examples of business format franchises include restaurants, fast-food establishments, hotels, real estate agencies, convenience stores, and automobile service centers. Clearly the fastest growing segment of franchising, business format franchises have doubled in number since 1972 (when they represented 42 percent of all franchises) and now account for nearly 74 percent of all franchise businesses.

Although these two types of franchises appear quite different on paper, the differences are sometimes blurred in practice. Equally unclear are the differences between the two types of franchises and numerous alternative business arrangements--dealerships, licensed agents, rack jobbers, distributorships, etc.--which fall outside the common definitions of a franchise.

---

[1] See "We Do It All For You," *Time*, July 16, 1990, pp. 42-44.

[2] Data on gasoline franchises from 1969-1988 can be found in: *Franchising in the Economy, 1986-1988*, U.S. Department of Commerce, February 1988.

The confusion is most pronounced in distinguishing between product and trade name franchises and more general dealership arrangements. In general, a product franchise involves conveyance of a detailed marketing plan and the authorization to use certain trademarks and other identifying symbols which are not provided in general dealership arrangements. This difference, while technically minor, presents a major difference in practice, since product franchises involve a more substantive contractual relationship and are subject to more strict regulation by federal and state agencies.

Given the absence of a single, generally accepted definition of a franchise, the most commonly recognized criteria for determining whether a business arrangement is a franchise is that incorporated by the Federal Trade Commission (FTC) in its 1978 regulatory rule governing disclosure requirements for franchises and business opportunities ventures.[3] Under this "franchise rule," a continuing commercial relationship would be classified as a franchise, and subject to the requirements of the rule, if three central characteristics are present:

1) The franchisee distributes products or services associated with the franchisor's trademark or identifying symbol;

2) The franchisor provides significant assistance and/or exercises significant control over the franchisee's method of operation; and

3) The franchisee is required to pay at least $500 in payments to the franchisor during the first 6 months of operation of the franchise.

While state definitions of a franchise may differ, particularly with regard to the threshold amount paid to acquire a franchise, all incorporate similar criteria as the FTC's franchise rule. Like the FTC, state agencies tend to regard business arrangements as franchises, and regulate them as such, if they incorporate this criteria. Regardless of what a business arrangement is called, how it is advertised or sold, or even whether it has a formal written contract or agreement, it is the nature of the contractual relationship between parties in the business arrangement that governs whether or not it is a franchise.

This somewhat imprecise approach to defining franchise relationships has instilled franchising with a dynamic quality that has facilitated its application to an ever expanding assortment of products and services. The concept of franchising has evolved with each new application and with the numerous interpretations and rulings of existing arrangements rendered each year by regulatory agencies and federal and state courts.

While potentially expansive, contemporary interpretation of franchise criteria has tended to be conservative, excluding numerous commercial arrangements which share many characteristics and problems of franchising. Critics of this approach claim this approach permits numerous arrangements to avoid the pre-sale disclosure and regulation required of franchises. Full extension of the franchise criteria, explained one franchise expert during Congressional hearings in 1988, would incorporate, among others, "tens of thousands" of independent agents and authorized dealers in the insurance, capital, and wholesale markets and would easily encompass over half of all U.S. retail sales.[4]

C. History and Development

Although considered a relatively recent development, franchising has existed in various forms since 1851 when Issac Singer accepted fees from independent salesmen to acquire territorial rights to sell his recently invented sewing machines. The concept gained broader recognition with its incorporation in the marketing efforts of General Motors after 1898, and its eventual use throughout the automobile and gasoline industries by

[3] FTC Trade Rule 436, "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities Ventures," 16 CFR Ch. 1, Part 436.

[4] Harold Brown, Hearing on Unfair Franchise Practices, Subcommittee on Antitrust, Impact of Deregulation, and Privatization, Committee on Small Business, U.S. House of Representatives, August 4, 1988. Document No. 100-72.

the 1930s. Elements of franchising were introduced into retail marketing with the development of the Ben Franklin general merchandise stores in 1920 and the emergence of a national network of A&W "walk up" root beer stands after 1925. Its expansion to an emerging service sector of the economy came with the initiation of national chains of Arthur Murray Dance Studios in 1938, Baskin-Robbins ice cream stores in 1940 and Duraclean carpet cleaning services in 1943.

The decade of the 1950s was a period of significant growth and innovation in franchising. An expanding post-war economy and a growing interstate highway system encouraged the growth of gasoline stations, restaurants and other franchise ventures directed to an increasingly mobile American public. A significant early convert to franchising was Harlan Sanders who initiated his Kentucky Fried Chicken franchise in 1950 and built a chain of more than 600 restaurants during the decade. Other franchisors, including Dairy Queen, Orange Julius, Tastee Freeze, Dunkin' Donuts and McDonald's followed Sander's lead in building national chains along the growing interstate highway system.

Franchising was introduced in the real estate and hotel industries in 1953 and 1954 and began appearing within such diverse service industries as dry cleaning, employment services and tax accounting between 1953 and 1956. In 1950 less than 100 companies had employed franchising in their marketing operations. By the close of the decade, more than 900 companies had franchise operations involving an estimated 200,000 franchised outlets.

The success and rapid growth of these early franchise chains, together with an expanding economy during the mid-1960s, set off a surge of franchising activity after 1964, as hundreds of companies turned to franchising to build national marketing networks. An estimated 100,000 new franchise businesses were initiated between 1964-1969. And while new franchising activity began to moderate after 1970, an additional 50,000 franchises were initiated between 1969 and mid-1973, when the total number of

franchised businesses reached a peak of 374,782.[5]

In the rush to begin franchising during this period, numerous franchise offerings appeared which were hastily structured, ill-conceived, and poorly capitalized. Others proved to be blatantly fraudulent. The growing number of public complaints, class-action law suits and business failures soon had a dampening effect on new franchise development and prompted a number of states to enact regulatory restrictions on franchise sales beginning in 1970.

But perhaps the harshest blow to franchising during this period came from abroad with the Arab oil embargo of 1973. Shortages of gasoline supplies forced the closing of nearly 32,000 franchised gasoline service stations between 1973-1976. In 1970, the nation's 181,000 franchised gasoline stations had accounted for 82 percent of product/trade name franchises and nearly 55 percent of all franchises. By 1976, gasoline's share of total franchising fell to 41 percent, and would continue to fall to 36 percent by the end of the decade. Although growth in business format franchises began to accelerate after 1976, adding more than 19,000 new franchises during 1976-1980, the increase failed to offset losses of more than 51,000 gasoline franchises during the decade. The 356,896 franchise businesses operating at the end of 1980 remained below the peak level achieved in 1973.

The relatively stagnant figures for overall franchise growth during the 1970s fail to reflect the significant increase in franchise sales which occurred despite adverse economic and regulatory conditions and the loss of over 25 percent of all franchise gasoline stations. Retail sales of all franchises grew by 140 percent, from $114 billion in 1971 to $274 billion at the end of 1979. Sales of product/trade name franchises, which reached $231 billion in 1980, and accounted for approximately 83 percent of annual franchise sales, increased by 129 percent between 1971-1979. While considerably smaller, aggregate sales of business format franchises grew by an impressive 200 percent, from $16

[5]Unless otherwise noted, all franchise data is from *Franchising in the Economy 1986-1988*.

billion in 1971 to $48 billion at the end of 1979. Rather than merely reflecting the high rates of inflation in the 1970s, this high rate of growth in franchise sales would characterize franchise development even after inflation rates declined sharply in the early 1980s.

D. Legal and Regulatory Influences

The 1950s established franchising throughout the economy as a cost-effective method of business expansion that was highly responsive to economic developments and to societal trends and consumer tastes. Its growth during the following two decades, while equally influenced by economic and social changes, would be shaped to a equal degree by legal and regulatory considerations.

Throughout the 1950s, franchisors had operated in an environment of uncertainty regarding the legal standing of franchise contracts, particularly with regard to federal antitrust statutes. In its first major case involving a contemporary type of franchise arrangement, the Supreme Court ruled in its 1949 decision in *Standard Oil Co. v. United States* that the franchise arrangement employed by Standard Oil, involving required purchase agreements with franchisees, was simply a sale on condition within the scope of the Clayton Antitrust Act that involved prohibited tying or exclusive dealing arrangements.[6] The decision was followed by a Federal Court of Appeals ruling in 1951 which asserted that the franchise contracts employed by the Richfield Oil Corporation were merely a guise to restrict competition.[7] The two decisions initiated a 30-year preoccupation with the antitrust aspects of franchising that served to stifle recognition and development of other legal principles and socio-economic considerations fundamental to franchising.

While the implications of the *Standard-Richfield* decisions for other, non-gasoline franchises remained unresolved well into

[6] *Standard Oil Co. v. United States*, 337 U.S. 293 (1949).

[7] *United States v. Richfield Oil Corp.*, 99 F. Supp. 280,287 (S.D. Cal. 1951), *aff'd*, 343 U.S. 922 (1952).

the 1960s, legal opinion began to turn against franchising and to discourage new franchising initiatives. Encouraging this negative view of franchising were the decisions and staff opinions of the Federal Trade Commission and the Antitrust Division of the Justice Department, which took a consistent view that franchising incorporated tying arrangements, and reflected imbalances in economic power that needed to be rectified by application of the antitrust laws.

This legal uncertainty was finally lifted in a series of decisions involving the Carvel Ice Cream franchise during 1964-1965.[8] In separate actions, the Federal Court of Appeals and the Federal Trade Commission recognized the trademark license as a central element in the legal structure of a franchise arrangement and declared that the restrictions of the franchise contract, rather than constituting illegal tying actions, were reasonably necessary to protect the trademark and the franchisor's goodwill. The Carvel decisions, in effect, drew upon trademark law to provide franchising with a shield against charges of illegal arrangements under the antitrust laws. The decisions helped ignite the surge of franchising activity in the late 1960s.

But the legal sanction given franchising by the Carvel decisions proved of short duration. Responding to the sharp increase in fraudulent franchise offerings and businesses failures, the FTC and the Justice Department became openly critical of the Carvel decisions, once again criticizing franchising as principally intended to create a system of captive dealers and as generally suspect under the antitrust laws.

A major reversal of *Carvel* soon followed in federal court decisions in *Siegel v. Chicken Delight* during 1970-1971.[9] The courts ruled that a franchisor's trademark, as merely a representation of product quality, was separate from other

[8] *Susser v Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y. 1962); 332 F.2d 505, 517 (2d Cir. 1964). FTC proceeding, *In re Carvel Corporation*, Trade Reg. Rep. 16,440 (June 12, 1963).

[9] *Siegel v. Chicken Delight*, 311 F. Supp. 847, 849 (N.D. Cal. 1970); 448 F.2d 43, 48-49 (9th Cir. 1971).

operational aspects of a franchise and could not shield its required purchase agreements from condemnation as illegal tying arrangements. The FTC followed with a decision of its own against the Chock Full O' Nuts restaurant franchise in 1973 condemning the franchisor's practice of requiring purchases of a substantial portion of the food used by franchisees as a tying arrangement and a violation of federal antitrust laws.[10] These actions set off a wave of franchisee class-action law suits between 1971-1975 and provided the legal basis for an industry-wide investigation of franchising practices by the FTC between 1975-1978.

This negative view of franchising guided federal legal and regulatory actions and frustrated new franchise development until late 1977, when the Supreme Court announced a major shift in antitrust doctrine in *Continental T.V., Inc. v. GTE Slyvania, Inc.*[11] The Court now distinguished between vertical restraints intended to impede competition and those, typical in franchise arrangements, that may have "redeeming virtues" in promoting interbrand competition by permitting a manufacturer to compete more efficiently or by assuring the safety and quality of products to consumers. It rejected the idea that antitrust law was intended to prohibit restrictions on the autonomy of independent businessmen where such restrictions might be beneficial to the marketplace.

The Court's position in *Sylvania*, and its application to key franchise cases during 1979-1981,[12] established a basis for ruling that franchise contracts and requirements are not illegal tying arrangements *per se*, but parts of an integrated method for doing business that must be assessed under rule of reason principles that look at its economic function in its entirety. The decisions had the effect of freeing franchising from the rigid application of

[10]Chock Full O'Nuts Corp., Inc., 83 F.T.C. 575, 594 (1973) *[FTC initial decision]*; 83 F.T.C. 575, 642 (1973).

[11]*Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

[12]*Krehl v. Baskin-Robbins Ice Cream Company*, (C.D. Cal. 1979), 664 F.2d 1348 (9th Cir. 1982); *Principe v. McDonald's Corp.*, 631 F.2d 303 (4th Cir. 1980).

antitrust doctrine that had clouded its development since the *Standard-Richfield* decisions nearly thirty years earlier.[13]

Sylvania also had the more immediate effect of persuading the FTC to terminate its investigation of franchising practices and to finalize its long-delayed regulations governing franchise sales and solicitations. These events combined to set the stage for a dramatic increase in franchising activity after 1980.

E. Franchising in the 1980s

Franchising emerged as a significant force in the nation's economy during the 1980s. While its growth may not have been as spectacular as some analysts have proclaimed, franchising has shown steady and impressive growth throughout the decade in both franchise sales and in the growth of new franchise businesses. Despite severe recessionary conditions during 1982-1983, the number of business format franchises increased by nearly 51,000 between 1980-1986.[14] The increase more than offset continued losses of 34,000 product/trade name franchises during this period and raised the number of franchise businesses (373,623) to roughly the level that had been achieved prior to the oil crisis in 1973.

Sales of products and services by all franchises grew by $198 billion, or 69 percent, during the 6 years between 1980-1986. Combined sales grew annually at an impressive rate of 9 percent during the recession years prior to 1983, then accelerated to nearly 11 percent between 1983-1986. Business format franchises continued to register particularly high levels of annual increases in sales, averaging 10 percent during 1980-1983 and 14.5 percent as economic conditions improved after 1983.

The close association of franchising with the services sector of the economy helped to insulate franchise businesses as a group

[13]For a detailed discussion of the impact of *Sylvania* and related cases, see Ernest A. Braun, "Policy Issues of Franchising," *Southwestern University Law Review*, Vol. 14, 1984.

[14]1986 was the last complete year for which the Commerce Department compiled data on franchise sales and growth. See Appendices.

from recessionary conditions in the early 1980s and to maintain continued growth in sales. In the 10 years between 1976-1986, the U.S. moved from a manufacturing to a service-based economy, with service industries officially accounting for half of the gross national product in 1986. Services remained relatively immune from the adverse economic conditions affecting manufacturing, finance, farming and other sectors during 1982-1984 and provided sufficient new employment to offset losses elsewhere in the economy. Even with a general economic expansion after 1984, service industries continued to provide 73 percent of new full-time employment in 1986 and account for 59 percent of total employment in 1988.

A variety of economic, demographic, and social factors influenced the growth of both the service sector and franchising during this period. The aging of the huge baby boom generation, the surge of women entering the workforce, the growing number of active retirees and the emergence of two-income families helped create tremendous demand for services ranging from day care and house cleaning to fast food and drive-through auto maintenance. Businesses also created new demand for services, seeking to cut operating costs by contracting for everything from janitorial services to personnel and accounting services. Changing attitudes regarding convenience and product quality, emerging technologies, mass advertising and other factors further encouraged development of a wide variety of service-oriented business opportunities.

A rising sense of entrepreneurism among key groups within the population, together with increasing limits on the ability of companies to expand by more traditional means, provided a growing pool of potential franchisees and franchisors willing to undertake new ventures in response to these business opportunities. Faced with intense competition for increasingly scarce top level corporate jobs, members of the huge baby boom generation have sought out entrepreneurial opportunities in increasing numbers as a means of gaining more enjoyment, less structure or greater

control over their working schedules.[15] A sense of narrowing opportunities has also prompted increasing numbers of women, minorities, early retirees and immigrants to seek franchise and other business opportunities.[16]

At the same time, existing businesses have sought alternative, less costly methods for expanding operations and distribution networks in response to rising capital costs, unfavorable tax changes and growing pressure to reduce costs and eliminate debt. Franchising has provided the means for merging the seemingly conflicting interests of existing businesses with those of aspiring entrepreneurs in a single process that promotes business expansion, entrepreneurial opportunity and shared cost and risk.

Prompted by these influences, the pace of franchising activities has accelerated since the mid-1980s. The number of companies initiating franchise programs has almost doubled during the decade, increasing gradually from approximately 1,600 in 1980 to 2,100 at the end of 1985, then exploding to an estimated 3,000 in 1989. Commerce Department projections of franchise growth also show an accelerating pace in the development of new franchises, estimating the addition of 50,000 new business format franchises during 1987-1988, nearly double the number added during 1985-1986.

The Commerce Department's estimate of 416,878 franchise businesses in operation in 1988 represents a net increase of 61,000 (17 percent) over the number in operation in 1980. This figure includes the addition of approximately 100,000 new business format franchises initiated during 1980-1988 (an increase of 52 percent),

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[15]See: Carol Steinberg, "Economic Lifestyle Changes Fuel Explosive Expansion," *Venture*, July 1988, pp. 56-63; Sanford L. Jacobs, "To Buy or Not To Buy," *Wall Street Journal*, Supplement, June 10, 1988; Jeremy Main, "A Golden Age for Entrepreneurs," *Fortune*, February 12, 1990, pp. 120-125.

[16]For discussion of franchising's appeal to women, minorities and retirees see, for example: Meg Whittemore, "Franchising's Appeal to Women, *Nation's Business*, November 1989, pp. 63-64; "More Firms Target Women as Prospective Franchisees," *Wall Street Journal*, April 19, 1989, p. B2; Wiley Woodard, "Exploring New Frontiers," *Black Enterprise*, September 1989, pp. 53-58; Meg Whittemore, "Franchising Draws Minorities," *Nation's Business*, April 1989, p. 68; Frank Mixson, "The Good Life Gets Better," *Entrepreneur*, January 1990, pp. 230-234; Mick Baker, "Change of Command," *Franchising World*, July/August 1988, pp. 28-33.

offset by the loss of an additional 40,000 product/trade name franchises. The estimated 27,273 new franchise units opened during 1988 represent the addition of one new franchise every 20 minutes throughout the year.

The 416,878 franchise businesses operating in 1988 employed an estimated 7 million workers and had estimated sales of $543 billion. Sales by business format franchises were estimated to have increased by 12 percent annually during 1987-1988, with a slower 4 percent growth in sales among product/trade name franchises. The estimated $543 billion in combined sales by all franchise businesses in 1988 represented an increase of 90 percent over annual franchise sales in 1980 and accounted for approximately one-third of all U.S. retail sales.

F. Franchise Data and Future Growth

The Commerce Department ceased collecting data on franchising in 1987 under directives from the U.S. Office of Management and Budget (OMB). Its data for 1986, with projections of franchise activity for 1987-1988, provide the only comprehensive picture of franchising now available. The collection of franchise data by the Department, according to OMB, did not have direct application to federal policymaking, since the federal government does not directly regulate franchise activity, and tended to duplicate data collection undertaken within the private sector.

In the absence of new Commerce Department data, analysts and business publications have tended to estimate current levels of franchise activity based upon the Department's earlier estimates for 1988. This has provided an unreliable and increasingly inaccurate statistical evaluation of current franchising. Two alternative surveys of franchising are published annually by national business magazines and have provided increasingly detailed and useful information.[17] But these remain far less comprehensive

[17] *Entrepreneur* Magazine's annual "Franchise 500" survey which appears in January of each year; *Venture* Magazine's annual "Franchisor 100" listing of the fastest-growing franchises which generally appears in the magazine's November issues.

and tend to focus on different types of information than the earlier Commerce Department surveys.

Although a private effort to replicate the data collection activities of the Commerce Department was initiated in late 1989 by the International Franchise Association (IFA), a national association of the major business format franchisors, it has been viewed skeptically. In Congressional hearings in 1988, Commerce Department representatives and franchise attorneys expressed concern that no private organization could command the resources, nor the desired response from business, necessary to compile comprehensive data over extended periods.[18] Concerns also exist regarding the IFA's limited tie to the product/trade name sector of franchising and the Association's own selective use of franchise data to present primarily a positive and expanding public image of franchising.

Even the earlier Commerce Department surveys can be criticized for including inaccurate estimates of franchise activity that tend to provide either an inadequate or exaggerated picture of both current and future levels of franchise sales and growth. On the one hand, the Commerce Department is criticized for distributing its annual surveys to a select group of franchisors, often ignoring many new or small franchise systems.[19] On the other hand, the figures used for both franchise growth and sales have been inflated with data for franchisor-owned outlets, which by definition and operation are not franchises. The Department estimates for 1988, for example, include approximately 92,000 "company-owned" outlets with combined sales of $97 billion. While the detailed tables in the Department's reports distinguished between franchisor-owned and franchisee-owned outlets, the figures most widely cited come from the report's conclusions and other summaries which include only the combined figures.

There has also been a tendency to further exaggerate these

[18] Hearings on Unfair Franchise Practices, pp. 40-42.

[19] Kathryn L. Boe, in written testimony, Hearing on Unfair Franchise Practices, p. 196.

already inflated estimates by applying the high growth rates for franchise development and sales of business format franchises to the aggregate figures for all franchises, ignoring the much lower sales growth and declining number of product/trade name franchises. In this way, the International Franchise Association, for example, has estimated that the number of franchise businesses will increase to 563,000 during 1990, with total sales of $716 billion and potential sales growth of more than $1 trillion in 1994.[20]

A more accurate estimate of franchising activity during 1990 would involve between 458,000-465,000 franchise businesses, with sales of between $605-612 billion.[21] Excluding the possibility of a major economic recession, the chances are extremely good that franchising will maintain current levels of growth throughout much of the 1990s. And even with these lower base figures, it is likely that annual sales of franchise businesses will exceed half of all retail sales in the economy by the end of the decade.

G. International Franchising

A major development in franchising during the past decade has been the expansion of American franchise businesses throughout the world. From Europe to South Asia and Australia, franchise companies have found receptive markets and significant opportunities to expand sales of products and services or to export their methods of operation. Unlike companies seeking only to market U.S. products or establish American-owned facilities, franchises offer opportunities for local ownership within a foreign market while providing American business methods, knowledge, and technology. This has made franchising particularly attractive in many parts of the world, with U.S. franchisors often finding themselves in the role of "recruits" rather than salesmen.

[20]International Franchise Association, "Special Advertising Section," *USA Today*, January 4, 1990; IFA, "Franchising Fact Sheet," revised March 1989.

[21]See estimates of franchise growth for 1989 and 1990 in appendix C.

Approximately 260 U.S. companies operated 17,000 franchise outlets outside the United States in the late 1970s. By 1986, the last year for which Commerce Department figures are available, the number of franchisors with foreign operations had increased to 354, with total outlets approaching 32,000. The Commerce Department's 1987 figures also indicated an additional 288 franchise companies with plans to expand abroad before 1990.[22]

Canada has provided the most popular foreign market for expansion by U.S. franchisors. As the nation's largest trading partner, Canada has proven extremely receptive to U.S. franchisors and has imposed few legal or regulatory restrictions on franchise operations. An estimated 240 U.S. companies operated 9,031 franchises in Canada in 1986, representing 29 percent of all U.S. franchises abroad. Canada has also developed a growing franchising sector of its own with some 1,200 Canadian and U.S. companies operating Canadian-based franchise operations with more than 60,000 outlets and annual sales of $67 billion. Franchising constitutes the fastest growing method of business expansion in Canada.[23]

Great Britain, Australia, and other British Commonwealth countries have also provided active and growing markets for U.S. franchises. American franchises, particular restaurant and fast food outlets, began to appear in Great Britain and Australia in the late 1960s. Franchising now accounts for more than 11 percent of annual retail sales in Great Britain. Australia ranked third in 1986 (behind Canada and Japan) in the number of operating U.S. franchises (2,816), followed by Great Britain with 2,415.

Japan has offered a large and extremely lucrative market for those U.S. franchisors that have been able to establish operations there. In 1987, nearly 70 U.S. companies operated a total of 7,366 franchise units in Japan. But entry into the Japanese market has proven to be extremely difficult and costly, with negotiation often

[22]Survey data by the Commerce Department in *Franchising in the Economy*, pp. 7-10.

[23]A good summary of Canadian franchising data and regulation is provided in: Stanley A. Brown, Marvin Martenfeld,"Oh, Canada!," *Franchise & Business Opportunities 1990*, November 1989, pp. 77-81.

extending for ten years or more. The U.S. franchise firms that have opened units generally have been involved in a limited number of acceptable markets--largely restaurants, fast food and convenience stores--and are principally the larger, more successful franchise systems in these fields capable of undertaking significant front-end investment.

Continental Europe also offers an attractive and increasingly important market for U.S. franchise operations. Franchising now accounts for 10 percent of retail sales in France and is increasing in popularity elsewhere in Europe. Unification of the economies of the twelve European Community (EC) nations after December 31, 1992 will provide a unified European market more than one-third larger than the United States. American franchisors are seeking to structure subfranchise arrangements within Europe in anticipation of new barriers to non-European firms and products after 1993. Facilitating introduction of new franchise networks within the EC is the adoption by the European Commission of a "block exemption" for franchising that permits, among other things, a single trademark application under uniform EC regulations instead of separate national registration requirements. Economic integration will remove many remaining technical and fiscal barriers between individual countries and create favorable conditions for expanding franchise operations already established within EC borders.[24]

International franchising has also become a two-way process, with increasing numbers of foreign companies seeking franchise opportunities in the United States. Patterns of foreign-affiliated franchise development have closely paralleled U.S. franchise activities abroad, with Canadian, British and Japanese firms accounting for a large proportion of all foreign-sponsored franchises.[25] Canadian companies have the largest presence in the

[24]Recent discussion of U.S. prospects in Europe include: "Franchising in a Borderless Europe," *Entrepreneur*, February 1990, p. 64; Michael Selz, "Europe Offers Expanding Opportunities to Franchisers," *Wall Street Journal*, July 20, 1990, p. B2.

[25]See Jeffrey A. Tannenbaum, "Foreign Franchisers Entering U.S. in Greater Numbers," *Wall Street Journal*, June 11, 1990, p. B2.

U.S. market and have generally followed the American pattern of building franchise chains by opening one unit at a time.

The Japanese have largely employed an alternative approach of acquiring existing franchise chains. Japanese acquisitions in the U.S., like American operations in Japan, have tended to focus on restaurants and fast food chains. However, the most significant Japanese acquisition to date has been the purchase by 7-Eleven of Japan Co., of a 75-percent interest of Southland Corp. which operates the financially troubled 7-Eleven franchise chain. British companies have employed both development and acquisition strategies to build sizeable U.S. franchise operations. In the past two years British companies have acquired majority interests in a number of major U.S. hotel chains and the sizeable but troubled Burger King franchise system. British companies have also developed a number of successful franchise chains, most notably the Fastframe U.S.A. network which operates 89 U.S. franchises offering custom framing and related services.

Perhaps the most widely noted development in international franchising was the opening in January 1990 of a McDonald's restaurant in Pushkin Square in Moscow. Ignored in much of the publicity surrounding this event was the fact that the McDonald's was neither a franchise nor an American venture. The restaurant was a non-franchised joint venture between McDonald's Canada and the Moscow City authorities. Also lost in the novelty of the event was the fact that American franchisors had already been in the Soviet Union for nearly 17 years as a result of a 1972 trade agreement permitting PepsiCo to open bottling operations and kiosk sales in Moscow.[26] Coca-Cola, Fanta and Astro Pizza had also preceded McDonald's in initiating operations in the U.S.S.R.

But it was the Pushkin Square McDonald's that captured the world's attention and epitomized the potentially significant role that franchising can play in the development of needed consumer and service sectors throughout Eastern Europe. A number of efforts

[26]Michael Parks, "For Pepsi, Road to Moscow Was a Trip Back in Time," *Washington Post*, July 6, 1988.

have already been initiated. Two months after the McDonald's opening, ComputerLand opened its first outlet to sell IBM computers on Kosygin Street near Moscow University. Pizza Hut and Baskin-Robbins have initiated arrangements to open outlets in the Soviet Union, while McDonald's Corp. has announced its own joint venture to develop restaurants in Hungary and Yugoslavia. An increasing number of U.S. hotel, fast food and service franchises have also indicated plans to develop outlets in Poland and Hungary.

The internationalization of American franchising presents U.S. franchisors with enormous opportunities. While this may represent franchising's ultimate triumph, it may bring with it increasing scrutiny of the issues and problems that have plagued franchising's development since the 1950s. Companies establishing franchises abroad have sought to apply American franchise agreements to foreign franchisees and extend coverage of U.S. laws to resolve disputes arising under these agreements. While this is clearly beneficial to franchisors, it is likely to give rise to growing complaints abroad regarding the excessive detail and restrictions of American contracts and perceived inadequacies in U.S. laws and regulations.

Before encouraging and facilitating widespread expansion of U.S. franchises throughout the world, a number of important policy issues should be examined. These involve the basic fairness of franchise arrangements in protecting the legitimate interests of franchisees, the adequacy of U.S. laws in protecting the legal rights and financial investment of both domestic and foreign franchisees, and the adequacy of current regulatory procedures for assuring proper structuring and operation of franchise arrangements. These issues have been at the center of a continuing national debate over franchising and provide an important and appropriate focus for Congressional inquiry.

II. Regulation of Franchise Sales and Disclosure

A. General

The growth and success of franchising has not come without considerable problems and controversy. Allegations of fraud, misrepresentation, non-compliance, and malfeasance have continued to plague franchise relationships and prompt calls for new regulation. Existing regulation has been inconsistent and generally inadequate. There is no federal law governing franchising relationships or practices, and federal franchise disclosure requirements have been weakly enforced. State franchise laws apply to only one-third of all franchises and impose requirements and procedures that are inconsistent with one another and with federal requirements. This confusing regulatory environment has frustrated franchisors and fostered continuing problems and complaints among potential investors and franchisees.

Legislative and regulatory efforts tend to reflect the concerns of franchisees, or potential franchisees, which fall generally within two broad groups. The first involves problems which arise prior to entering into a franchise relationship, particularly deception or impropriety in the presentation, solicitation or sale of a franchise opportunity. The second group involves problems arising within ongoing franchising relationships, generally involving contract performance, termination, or renewal of franchise agreements.

Federal regulatory efforts since the late 1960s have focused almost exclusively on the first group of problems involving solicitation and sales of franchise opportunities. Two factors have encouraged this emphasis. First, there is no federal statute broadly authorizing federal intervention in either franchise sales or business operations. The two federal statutes that specifically address franchise arrangements have been narrowly defined to address the legal standing of automobile franchisees and to prevent

arbitrary termination of gasoline franchises.[27] Lacking broader statutory authority, the Federal Trade Commission (FTC) has acted administratively to regulate the solicitation and sale of franchises as part of its broader responsibility, under Section 5 of the Federal Trade Commission Act, to investigate and remedy deceptive business practices involving misrepresentation of fact in advertising, product sales, and investment in business opportunities.[28]

The second factor prompting a federal emphasis on franchise sales is the fact that the most serious and widespread abuses in franchising during the 1960s and early 1970s were found to involve actions or misrepresentations occurring prior to the initiation of franchise agreements. In numerous proceedings and investigations during the 1970s, the FTC documented complaints of fraud or misrepresentation against more than 170 franchisors filling some 5,700 pages in ten volumes of public records. Based on this record, the Commission concluded there had been "widespread evidence of deceptive and unfair practices" in franchise solicitation and sales. Most common abuses were found to involve misrepresentation or failure to disclose material facts relevant to the true nature or value of a franchise, and the use of unsubstantiated earnings claims or deceptive earnings representations. Such abuses had occurred, the FTC concluded, due to the "informational imbalance" that existed between franchisors and potential franchisees.[29]

The FTC was not alone in uncovering patterns of fraud and misrepresentation in franchise sales. A number of states were prompted to enact franchise regulatory statutes in the 1970s in response to documented losses of millions of dollars in fraudulent

[27]Automobile Dealers Franchise Act of 1956, 15 U.S.C. 1221-1225; Federal Petroleum Marketing Practices Act of 1978, 15 U.S.C. 2801-2806.

[28]Federal Trade Commission Act, 15 U.S.C. 41-58.

[29]Final Franchise Rule, Part 436 - Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures. *Federal Register*, Vol. 43, December 21, 1978, see pp. 59614-59637.

franchising ventures. Investigations by the Attorney General's office in New York State, for example, revealed losses of more than $40 million in franchise fraud by 14,000 citizens.

In attempting to redress the informational imbalance between franchisors and franchisees, the FTC and various state governments have adopted regulatory procedures involving pre-sale disclosure of material facts of a franchise offering, with penalties for false or incomplete information. This approach was first adopted in the California Franchise Investment Act of 1970, which had its roots in earlier, unsuccessful efforts by the state to classify franchise opportunities as investment securities for purposes of applying existing disclosure and registration requirements under state securities laws. The pre-sale disclosure procedures of the California law influenced adoption of similar requirements by 14 states between 1971-1980 and provided the model for the FTC's franchise disclosure rule.

The presence of disclosure requirements and procedures at both the federal and state levels has substantially improved the general structuring of franchise offerings and greatly enhanced investor confidence in franchise opportunities. But misrepresentation and fraud in franchise sales have not been eliminated. Reports published in the mid-1980s in *Investor Alert*, a newsletter published jointly by the North American Securities Administrators Association and the Council of Better Business Bureaus, estimated that tens of thousands of individuals continue to lose as much as $500 million annually in franchise and business opportunities fraud. State securities administrators have also reported growing numbers of complaints of franchise fraud and increasing enforcement activity.

B. The FTC Franchise Disclosure Rule

Federal authority to regulate franchise sales derives from the FTC's Trade Rule 436--"Disclosure Requirements and Prohibitions

Concerning Franchising and Business Opportunities Ventures."[30] This "Franchise Rule" is intended to provide prospective franchisees with the information necessary to make informed decisions by requiring franchisors or franchise brokers to disclose detailed information relating to twenty separate aspects of a franchise offering. Information to be disclosed includes all relevant facts about the identity, location, business experience and financial background of the franchisor, detailed descriptions of the franchise opportunity, including all initial and continuing fees and payments, and an explanation of all terms, obligations, conditions and requirements of the franchise agreement.

Under the rule franchisors are not required to make claims regarding actual or potential sales, income, or profits of existing or proposed franchises. If a franchisor chooses to make such claims, however, the rule prescribes the manner in which claims can be made and requires that a reasonable basis exist to substantiate the accuracy of all claims. Failure to provide information required under the rule, or providing of false information or information inconsistent with that required under the rule, are considered violations of the FTC Act and subject to civil penalty actions with fines of up to $10,000 per violation.

To simplify disclosure and encourage compliance with both federal and state disclosure requirements, the FTC permitted franchisors to use either the disclosure format provided in its franchise rule or a similar set of detailed guidelines incorporated in the Uniform Franchise Offering Circular (UFOC). The UFOC had been developed by the Midwest Securities Commissioners Association in 1975 to eliminate confusion and assist compliance by national franchisors who were confronted with a growing number of divergent state disclosure requirements. Having a similar basis in the detailed disclosure criteria of the 1970 California franchise statute, the UFOC requires information under twenty-three parts, or "items," which closely approximate those of the FTC rule. While acknowledging differences between the two sets of guidelines, the FTC determined that use of the UFOC, and any minor modifications made by states which do not diminish its requirements, would provide protection to prospective franchisees "which is equal to or greater than that provided by the (federal) rule."[31] Having the advantage of prior use and detailed instructions, the UFOC became the disclosure format used almost universally by franchisors.

Franchise disclosure documents, or "circulars," prepared by franchisors under the UFOC are subject to review and enforcement by both the FTC and state agencies. In general, the FTC presumes the adequacy and accuracy of circulars submitted under state registration procedures, while reserving authority to determine compliance in non-regulation states and to enforce broad violations of its rule by national franchisors.

While claiming this broad authority, the FTC has often been reluctant to use it. For most of the period from 1979 through 1987, the agency's principal approach to rule enforcement involved monitoring compliance and encouraging franchisors to correct potential violations. While this approach was well-suited to the anti-regulation orientation of the Reagan Administration, it was severely criticized by state administrators and franchisee organizations. During this seven-year period, the FTC brought a total of fifteen enforcement actions--thirteen involving violations of the franchise rule and two involving misrepresentations by franchisors falling outside the scope of the rule. In contrast, state regulatory agencies commenced 1,026 enforcement actions during the three-year period between 1986 and early 1989.

A restructuring of enforcement responsibilities within the FTC in late 1987 brought new staff and a pro-enforcement orientation into the agency's Marketing Practices Division, the office within the FTC's Consumer Protection Bureau with responsibility for enforcing the franchise rule. Since that time, the Division has doubled the agency's enforcement actions in this area, commencing

[30] 16 CFR Ch. 1, Part 436.

[31] Final Franchise Rule, p. 59752.

twelve actions against franchisors under the rule and two additional actions against franchisors for non-rule violations. At least five additional actions involving significant franchise rule violations are expected to be concluded in 1990.

In addition, the FTC has also initiated several controversial investigations to determine whether various business operations qualify as franchises for purposes of federal regulation. A 1989 investigation of the Snap-On Tool Company, for example, expanded application of the franchise rule by determining that a company cannot avoid regulation as a franchise simply by not charging an up-front franchise fee, but requiring payments in addition to the cost of ordered merchandise. A recently concluded investigation of the Benetton Group, on the other hand, concluded that the outlet operations of the Italian clothing maker did not embody a "hidden" franchise relationship, and that many of the complaints against the company result from the inexperience of outlet owners and the absence of detailed contractual agreements, territorial arrangements and other factors that characterize most franchises.

Despite this increase in enforcement activity, the FTC is not in a position to continue expanding enforcement to levels necessary to protect consumers from franchise fraud. The agency is underfunded and understaffed, employing less than half the staff it had when the franchise rule took effect in 1979. Ultimate responsibility for bringing enforcement actions falls upon a core staff of sixteen attorneys, whose efforts must be divided between franchising and numerous other deceptive practices cases.

Given these circumstances, the FTC is severely restricted in its ability to investigate and prosecute franchise rule violations and has tended to concentrate its efforts on cases where substantial losses or widespread fraud have been documented. As a result, franchisors have been able to commit random violations of FTC guidelines with relative impunity. A legal right of action for franchisees or potential investors to sue for damages caused by such actions, which the FTC recognized as essential for effective enforcement, has been consistently denied by the federal

courts.[32] As a result, the agency must continue to rely on state regulatory agencies to investigate and prosecute the overwhelming majority of franchise rule violations.

C. State Regulatory Activity

Most states regulate some aspect of franchise sales or relationships under a variety of business opportunity, unfair trade practices and industry regulation statutes. All states, for example, have enacted some form of a "little FTC Act" prohibiting unfair methods and deceptive acts in trade or commerce. Nearly three-quarters of the states have business opportunity statutes prohibiting fraud and misrepresentation in the sale of franchises and other business opportunities. Most states have industry relationship laws regulating automobile dealerships, gasoline franchises, farm equipment dealers or alcoholic beverage distributorships. And seventeen states have adopted laws governing some aspects of the substantive relationship between franchisors and franchisees.[33]

But the states generally considered to be "regulating" states in franchising are the fifteen states which have enacted statutes specifically regulating franchise solicitations and sales. These states account for one-third of the nation's population, more than a third of all franchises, and the overwhelming majority of all franchise enforcement actions. Thirteen of these states require both pre-sale disclosure and registration of disclosure documents with state agencies.[34] Of the two remaining states, Oregon has enacted specific franchise disclosure requirements without requiring a registration process, while Michigan requires disclosure but dropped registration procedures in 1984 in favor of

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[32]Harold Brown, "Pre-empting State Pre-Sale Disclosure Regulations," *New York Law Journal*, May 9, 1989.

[33]Detailed discussion of these state franchise "fairness" laws is included in Part III-B.

[34]California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

a "postcard" notice filing format in which franchisors merely indicate their intent to sell franchises within the state.

The thirteen states with franchise disclosure and registration procedures operate under statutes which are relatively uniform in requiring comprehensive pre-sale disclosure to prospective franchisees using UFOC guidelines. These statutes also impose similar procedures for state agency review and approval of franchise circulars prior to permitting a franchise sale. State agencies may require changes in a circular, request additional information or documentation, or they may refuse to register the franchise offering. All thirteen statutes provide civil and criminal sanctions for violations, while most provide remedial rights for individuals injured by such violations.

While the state statutes have significant similarities in requirements and procedures, many impose additional requirements or specific language that are not incorporated in standard UFOC guidelines. Disclosure requirements must also reflect requirements in state franchise fairness laws, business opportunity laws and other state statutes. Disclosure requirements in Illinois, North Dakota, South Dakota, New York, and Washington, for example, require franchisors to incorporate specific language consistent with state requirements regarding franchise renewal, arbitration, termination, or inventory repurchase requirements. Wisconsin requires changes in disclosure documents to reflect state policies prohibiting material changes in franchise contracts upon renewal. Virginia requires an estimate of annual costs incurred in operating a franchise. Minnesota requires formal acknowledgement of a franchisee's right to use the franchisor's trademarks. California requires inclusion of statements noting the limited enforceability under state law of covenants of noncompetition.[35]

Considerable inconsistency also exists in state agency interpretation, evaluation and implementation of common statutory

[35]A detailed summary of various state provisions is provided by William B. Cherkasky, President, International Franchise Association, Comments on FTC Advance Notice of Proposed Rulemaking (File No. R511003), June 15, 1989, pp. 8-12.

requirements and procedures. While all states review franchisor's financial statements to determine ability to fulfill obligations to franchisees, actual capitalization requirements and accounting practices can vary widely. Some states require a franchisor to place fees in escrow pending satisfaction of pre-opening obligations, while others have no such requirements. Some agencies require surety bonds; others do not. A franchisor's net worth may exceed minimum requirements in one state, but be ruled insufficient in another. Franchise attorneys point further to the frequent inconsistency of interpretation among individual regulators, claiming that similar contract provisions and corresponding UFOC materials are often treated differently even among different regulators within the same state agency.[36]

These variations in state law and procedure confront franchising companies with a confusing patchwork of regulatory requirements that can make compliance not only burdensome but potentially hazardous. Technical non-compliance with a state franchise registration law, even if due to inadvertent or honest mistakes, can taint a franchise program or, at least, delay or discourage franchise sales. The process of compliance is difficult even for established national franchising firms which must either constantly revise disclosure documents or maintain stocks of "upwards to eighteen different disclosure documents."[37] And given the differing applicability standards of state laws, a single franchise sale can require preparation of two or three different sets of state disclosure documents depending upon the location of the franchisor, the franchisee, and the proposed franchise.[38]

The difficulty of compliance with state registration procedures has been compounded in recent years by a significant

[36]Discussion of the procedural and interpretative problems encountered is provided in the letter of the Business Law Section of the State Bar of California, in response to the FTC Notice of Proposed Rulemaking-Franchise Rule (File No. R511003), July 21, 1989.

[37]Byron E. Fox, written testimony, Hearing on Unfair Franchise Practices, p. 95.

[38]William Cherkasky, pp. 22-24.

increase in state legislative activity that has produced numerous changes in state franchise statutes and business opportunity and industry relationship laws. During 1985-1986, legislation was introduced in twenty-two states affecting some aspect of franchise sales or relationships--sixteen offering amendments to existing franchise disclosure and fairness statutes, together with numerous amendments to dealer relationship and business opportunities laws. During 1987 the number of franchise-related legislative proposals increased substantially, with a record forty-nine new statutes or amendments enacted into law. This increasing pace of legislative activity continued into the states' 1989 legislative sessions, according to *Business Franchise Guide*, with the enactment of forty-three "franchising" statutes by twenty-five state legislatures. The new laws varied in scope from amendments to the general franchise regulatory statutes in Michigan, Minnesota, New York, and North Dakota to more specific revisions in various state dealer relationship laws.[39]

The increasing complexity of state franchise disclosure requirements and registration procedures has prompted several initiatives to promote greater uniformity and coordination in franchise regulation. The National Conference of Commissioners on Uniform State Laws (NCCUSL) in August 1987 recommended a Uniform Franchise Act for consideration by state legislatures.[40] The proposal called for uniform standards of pre-sale disclosure and adoption of a weakly defined "good faith" standard to govern ongoing franchise relations. Strongly reflecting the NCCUSL's long-standing predisposition to regulate through self-implementing requirements rather than regulating bureaucracies, the Uniform Act also proposed the replacement of existing state registration requirements with a simplified notice filing requirement modeled

[39]"New State Laws," *Business Franchise Guide*, Number 113, 1989, p. 10.

[40]Uniform Franchise and Business Opportunities Act, National Conference of Commissioners on Uniform State Laws, approved and recommended for enactment in all states, August 1987.

on the revised Michigan law.[41]

An alternative Model Franchise Investment Act was circulated in draft form in mid-1989 by the North American Securities Administrators Association (NASAA).[42] Embodying the strong regulatory approach of officials of the major franchise regulating states, the proposal takes the opposite approach of NCCUSL's model statute by proposing full administrative review and registration of disclosure documents, together with a strongly defined good faith standard of conduct and specific restrictions relating to franchise termination, renewal and transfer. The model act also proposes stronger enforcement authority for states, as well as a broad right of action for franchisees and potential franchisees to sue for damages incurred in connection with violations of the act.

The NCCUSL and NASAA proposals illustrate, at least, some uniformity of opinion that change is needed in franchise regulation and provide the parameters for broader public debate. To date, however, no state has acted to adopt new guidelines modeled on either proposal. NCCUSL's proposals are already considered dead by some analysts,[43] while NASAA's proposals have yet to be finalized for formal consideration by the states.[44]

Despite increasing complaints of inconsistent and excessive regulation, little evidence has been produced to show that current disclosure policies and procedures have significantly added to franchising costs or adversely affected franchise sales. On the contrary, there appears to be broad recognition that existing

[41]Andrew C. Selden, "Public Regulation of Franchising: Choking the Goose that Lays the Golden Eggs?" *Franchise Law Journal*, Fall 1989, p.16.

[42]Model Franchise Investment Act, Public Comment Draft, North American Securities Administrators Association, Inc., July 17, 1989.

[43]See, for example, Harold Brown, "Proposal on Pre-Sale Disclosure and Conduct Regulation," *New York Law Journal*, September 29, 1989.

[44]NASAA's Model Franchise Investment Act was formally revised in June 1990 in preparation for its adoption by the Association's membership in August 1990. Among other changes, the draft removes a number of controversial franchise relationship provisions that are to be incorporated in a separate legislative proposal.

federal and state regulation has significantly benefited franchise growth by enhancing public confidence in franchising generally. As two franchising attorneys noted in 1988,

> as evidenced by the growth of franchising, these laws do not appear to have impeded growth; indeed, it has been suggested that these laws have helped eliminate or reduce potential abuses, and by doing so, instilled added confidence among prospective franchisees in the viability of the business in which they have invested.[45]

D. The Problem of Earnings Claims

A continuing problem in franchise regulation centers on the disclosure of so-called "earnings" information about franchise opportunities. This involves estimates or other representations by a franchisor of what a prospective franchisee might expect in terms of sales, income and potential profit from a franchise investment. This issue presented a particularly difficult problem for the FTC when developing its franchise rule prior to 1979 and remains the central issue in the debate over inconsistencies in federal and state disclosure requirements.

In explaining the basis for its franchise regulatory rule in December 1978, the FTC noted that the most common abuses in franchise sales and solicitations involved unsubstantiated earnings claims or deceptive earnings representations. The "prevalence of misrepresentation of earnings," noted by the FTC, involved statements made in advertisements and promotional materials as well as those made orally by franchisors or their representatives.[46] While recognizing this problem, the FTC was confronted with a dilemma in proposing a solution. It could not require franchisors to disclose specific earnings information, since financial data would not be available for new franchise offerings, and information for existing franchises might be inappropriate or misleading when applied to new market areas or locations. On the other hand, it couldn't prohibit earnings disclosure without depriving potential franchisees of the most important information on which to base an investment decision.

The FTC adopted an approach falling somewhere in between these options which neither requires an earnings claim nor prohibits it. While not insisting that earnings claims be made in connection with the offer of a franchise, the franchise rule requires that if a claim is made, its substance and presentation must conform to guidelines set forth in the rule. All others would be prohibited. Specifically, earnings claims are permitted where (1) reasonable proof exists to support the accuracy of the claim; (2) the franchisor has in its possession, at the time the claim is made, information sufficient to substantiate the accuracy of the claim; (3) the claim is geographically relevant to the prospective franchisee's proposed location; and (4) the earnings claim is provided to the prospective franchisee at the same time as the other required disclosure documents.[47]

The rule interprets earnings claims broadly to include any "oral, written or visual representation to a prospective franchisee, or for general dissemination in the media, which states or suggests a specific level or range of potential or actual sales, income, gross or net profits."[48] It also includes any presentation of facts from which a prospective franchisee can readily infer a specific level or range of income, sales or profits.

The FTC's guidelines impose additional procedural requirements that have added considerable complexity to the task of preparing an acceptable earnings claim. These involve the inclusion of an explanation of the bases and assumptions upon which an earnings claim is made, together with statistical information explaining the number and percentage of outlets that have earned at least the amounts described in a claim and documentation of specific periods

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[45]Statement of Philip F. Zeidman and John M. Tifford (firm of Brownstein, Zeidman and Schomer, Washington, D.C.) December 30, 1988, before the United States International Trade Commission, "Services Sector Profiles and Barriers to Trade in Services--An Investigation to Provide Information for Use by the United States Trade Representative in Connection with Trade Negotiations on Services in the Uruguay Round of Multinational Trade Negotiations," Investigation N. 332-357.

[46]Final Franchise Rule, pp. 59629-59632.

[47]Final Franchise Rule, pp. 59617-18; 16 CFR Ch. 1, 436.1(b).

[48]Final Interpretive Guides, FTC Franchise Rule, *Federal Register*, August 24, 1979, p. 49982.

for which data was collected from outlets to support the claim.

For all its detail, the FTC's earnings disclosure requirements presented franchisors with little specific guidance as to what the FTC would accept as "reasonable" proof for an earnings claim, what level and type of information would be considered "sufficient" to substantiate such claims, or what type of information the agency would consider "relevant" to a specific franchise location. This problem was partially addressed by the agency's willingness to accept disclosure under the alternative UFOC guidelines. Grounded more firmly on actual experience and regulatory practices of state securities administrators, the UFOC's "Item 19" provided a more detailed framework for preparing an acceptable earnings claims.

Guidelines for Item 19, in effect, translated the Rule's broad requirements into specific procedures, such as preparing a break-even sales analysis under generally accepted accounting procedures, and defining "sufficient" information as including, for example, data collected from a substantial number of units, as understood to be significant relative to the franchisor's total number of franchises. Item 19 also simplified disclosure in specific areas, permitting, for example, the opening of the books of an existing franchise unit that is being refranchised in lieu of preparing a formal earnings claim.[49]

While providing more workable guidelines for compliance than the Franchise Rule, the UFOC's Item 19 was increasingly criticized by franchisors as being so strict and requiring such excessive documentation that it made it extremely difficult, if not impossible, to prepare an earnings claim.[50] Compliance has been described as requiring "an incomprehensible number of variables...to construct a trustworthy data base of historical information, all of which is expected to be distilled into statistically definable conclusions, like average, percentage and

[49]Ellyn L. Brown, Securities Commissioner, State of Maryland, Comments to FTC on Advance Notice of Proposed Rulemaking (File No. R511003), June 20 1989, p. 5.

[50]Buck Brown, "Franchisers Resist Earnings Projections," *Wall Street Journal*, July 7, 1988, p. B1.

median (sales and earnings)."[51] Not only are such statistical constructs difficult to develop, they are viewed as largely irrelevant to answering the essential question of what a franchisee can expect to earn in a specific franchise venture.

Franchisors have now concluded that "it is impossible to predict what level of earnings or profit any new business will make," particularly in the case of franchises involved in service businesses.[52] Central to the problem is not only the difficultly of transposing data from one geographic area to another, but of factoring in such critical, but intangible factors as varying levels of ability and effort of individual franchisees. According to one franchise attorney,

> The difference of individual effort is subtley present in the historical data of operating franchises and dramatically apparent in the success of a new franchisee. Individual characteristics, such as skill, energy, ability, personality, are even more impactful as the character of a franchise appears to be more personal service oriented than product driven. Such is the inherent weakness in attempting to trust numbers based upon partially unquantifiable factors.[53]

An equally serious problem is found in franchisors' claims that the disclosure restrictions in Item 19 have discouraged franchisors from offering earnings information to prospective franchisees and thus "caused some of the very problems that the restrictions were designed to eliminate."[54] A number of specific Item 19 requirements are cited in this regard. The requirement that claims be supported with data from a substantial number of units, for example, is seen as essentially prohibiting claims by newer franchising companies. The need to prepare a break-even sales analysis also appears to have deterred disclosure where franchisors have felt unable to provide accurate cost operations

[51]John P. Moravek, Century 21 Real Estate Corporation, Comments to FTC on Advance Notice of Proposed Rulemaking (File No. R511003), June 15, 1989, p. 2.

[52]Glen Nelson, General Counsel, Servpro Industries, Inc., Comments to the FTC on Advance Notice of Proposed Rulemaking (File No. R511003), April 11, 1989, p. 2.

[53]John P. Moravek, p. 3.

[54]William Cherkasky, p. 4.

data for a large number of franchises.[55]

The procedural disincentives to preparing written earnings claims are compounded by legal considerations. Preparing written estimates of potential earnings is considered risky from a legal standpoint and franchise counsels generally advise against them out of fear of both regulatory and legal actions. Franchisors object to the prospect of having to defend the accuracy of claims which require projections of general economic activity, buying trends, interest rates, etc., or which necessitate assessment of unknown or intangible factors such as the ability of potential franchisees. Franchisors are also reluctant to make earnings claims for fear they may be held as guarantors of projected income levels by courts and regulatory agencies.[56]

The question of whether earnings claim disclosure requirements might be discouraging franchisors from preparing earnings claims was first raised in a 1984 FTC study of the impact of the franchise rule on franchisees and prospective franchise investors. The study found that a minority of the franchisees (approximately 27 percent) reported receiving any form of written earnings claim from a franchisor prior to investing in the franchise and, of this number, less than a fifth (5 percent of the total) were provided with appropriate disclosure materials.[57] A survey of franchisors the following year found that almost two-thirds of franchisors agreed with the conclusion that existing disclosure regulations made it difficult to make earnings claims and that this ultimately hurt prospective franchisees.[58]

[55]Ellyn L. Brown, p. 5. See also, Warren Lewis, *Earnings Claim Study: A Study of Franchisors Registered with the Securities Division of the State of Maryland*, 1988, p. 17.

[56]Michael C. Hill, Corporate Counsel, Coldwell Banker Residential Affiliates, Inc., Comments to FTC on Advanced Notice of Proposed Rulemaking (File No. R511003), June 13, 1989, pp. 2-3.

[57]Audits & Surveys, Inc. *A Study of the Impact of the Franchise Disclosure Rules on Franchisees and Potential Investors*, 1984.

[58]Opinion Research Corp., *Final Report of a Survey to Evaluate the Economic Impact on Franchisors of the FTC Trade Regulation Rule Entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,"* 1985, p. I-6.

A more recent study of all franchisors registered to sell franchises in Maryland found that only 64 out of 557 franchise companies (11.5 percent) provided written earnings disclosures.[59] This finding closely approximated broader estimates by franchise experts that less than 15 percent of franchisors nationally offered formal earnings projections in their disclosure materials.[60] The author of the Maryland study concluded that "in the absence of a requirement that written earnings claims be made, the vast majority of franchisors do not make them."[61]

The low incidence of formal earnings disclosure by franchisors raises a number of serious policy problems. While franchisors have denied giving prospective franchisees what is clearly the most essential data required for them to make an important investment decision, the reality is that "they cannot sell a deal unless they provide this data in some fashion."[62] Whether or not franchisors choose to include written earnings materials in their disclosure documents, their sales representatives are under constant pressure from prospective investors to provide sales, cost and profit information.[63] And for franchisors to recruit a franchisee who shows little interest in prospective sales, gross earnings and net profits and make an investment without such information, would be to recruit the "worst possible candidate for a franchise."[64]

The pressure to provide some information about potential earnings often results in earnings claims being made orally or by employing a variety of other devices. The most common of these is what has been called the "table napkin *pro forma* statement," in which an earnings projection is written on a napkin or scrap of

[59]Warren Lewis, *Earnings Claims Study: A Study of Franchisors Registered with the Securities Division of the State of Maryland*, 1988, p. 17.

[60]Buck Brown, p. B1.

[61]Warren Lewis, p. 4.

[62]Harold Brown, Hearings on Unfair Franchise Practices, p. 14.

[63]Warren Lewis, cited in Kelvin Maler, "Franchise Reporting Termed Too Loose," *Washington Times*, March 23, 1988.

[64]Harold Brown, Hearings on Unfair Franchise Practices, p. 15.

paper when finalising a franchise sale.[65] Other devices include sending a prospective franchisee to existing franchises where they can "get the low down" on potential earnings, or permitting a prospective investor to devise their own set of acceptable profit and loss figures for informal comparison with possible figures of the franchisor.[66]

The 1984 survey of franchisees illustrated the extent to which such representations have been made. The survey concluded that most of the potential franchisees who sought earnings information were able to obtain it. Over half reported receiving information that was presented orally, while 22 percent received some form of written claim separate from their formal disclosure materials.[67] Four years later the author of the Maryland study observed,

> Claims are being made without the proper written backup. That's the problem we are having now. It's misleading and illegal...[68]

It has become a common view that the disclosure process for franchise earnings is "so far from ideal as to be unworkable."[69] The process not only discourages franchisors from preparing the type of information most needed by prospective franchisees, but permits them to avoid accountability for most of the illegal earnings claims that are provided. The widespread use of "under-the-table" earnings claims by franchisors has prompted one franchise expert to conclude, "It is almost certain that this formula simply produces 'liars.'"[70] In February 1989 the FTC formally acknowledged that the disclosure process might be having the "unintended" effect of reducing the availability of reliable

[65]David Diamond, "The Dark Side of Franchising," *The New York Times*, January 12, 1986.

[66]Harold Brown, Hearings on Unfair Franchise Practices, p. 14.

[67]1984 Impact Survey, p. 33.

[68]Warren Lewis, "Franchise Reporting Termed Too Loose."

[69]Kathryn L. Boe, Hearing on Unfair Franchise Practices, p. 192.

[70]Harold Brown, Hearings on Unfair Franchise Practices, p. 14.

information. The existing earnings claim disclosure requirements, it concluded,

> either may be reducing the availability of relevant information, or assuring that it is provided, if at all, in under-the-table circumstances that cast doubt on its accuracy and reliability.[71]

F. The FTC and Preemption of State Law

Acknowledging the inadequacies of the UFOC's approach to earnings claim disclosure, the North American Securities Administrators Association adopted major revisions in its Item 19 guidelines in November 1986. The revisions were intended to liberalize earnings disclosure procedures "so that franchisors would be permitted, and perhaps even encouraged, to make more information available to prospective franchisees."[72] The revisions were the product of a year-long drafting effort by the Association's Franchise and Business Opportunity Committee with significant participation by both franchisors and franchisees.

NASAA's revised Item 19 guidelines differed significantly from the old Item 19 requirements in both philosophy and substance. The new requirements eliminated much of the detail and complexity of the original Item 19. It did not articulate a disclosure format nor identify specific information to be disclosed. Taken as a whole, however, the revised guidelines were generally viewed as adequate to "establish a framework within which earnings-related information" can appropriately be disclosed.[73]

As in the past, the revised disclosure guidelines did not require franchisors to make earnings claims, but where claims are made it required that they be included in the disclosure circular and meet new substantiation requirements incorporated in Item 19.

[71]FTC, Advance Notice of Proposed Rulemaking: Trade Regulation Rule--Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, *Federal Register*, February 16, 1989, p. 7043.

[72]John C. Baldwin and John Hayden, Comments of NASAA to the FTC on Advance Notice of Proposed Rulemaking (File No. R511003), June 16, 1989, pp. 9-10.

[73]Alan E. Korpady, "1986 Revisions to Items XIX and XX of the UFOC Guidelines," *Franchise Law Journal*, Winter 1987, pp. 6-7.

In general, these requirements were considered "quite simple" in stating only that an earnings claim satisfy the broad requirement that it "have a reasonable basis at the time it is made."[74] It included no specific definition or guideline on what constitutes a sufficiently "reasonable" basis. A new section 19-B provided only that "an earnings claim shall include a detailed description of its factual basis and the material assumptions underlying its preparation and presentation."[75]

While this approach offered a considerable degree of latitude in fashioning earnings claims documentation, it reflected an emerging consensus among both franchisors and regulators that, of the two groups, franchisors would have greater access to the information and expertise necessary to make determinations regarding reasonableness. At the same time, however, the revised guidelines placed upon the franchisor the burden of proving, under statutory antifraud standards, not only that a basis exists for a earnings claim, but that the basis was reasonable at the time it was given.[76]

The comparative simplicity and flexibility of NASAA's Item 19 revisions generated widespread support from franchise regulators as well as from franchisors. The new Item 19 was unanimously adopted by NASAA's membership on November 21, 1986. Six months later it was adopted by the FTC for use in meeting federal disclosure requirements. The new Item 19 was widely applauded by franchisors and their attorneys who believed the changes would permit "an open-ended, flexible opportunity to publish almost any earnings information" and that it would "ease substantially the compliance costs and burdens connected with making earnings claims" to prospective franchisees.[77]

[74]Harold Brown, "The Numbers Game," *New York Law Journal*, February 1, 1988.

[75]UFOC, Requirement 19.B.

[76]Harold Brown, "The Numbers Game;" Alan Korpady, p. 8.

[77]Andrew C. Selden, "The Seasons of Franchising," *Franchise Law Journal*, Fall 1987, p. 22; John C. Baldwin and John Hayden, p. 11.

In accepting NASAA's revised Item 19 in June 1987, the FTC explained it had acted "in an effort to minimize franchisor compliance burdens."[78] To further assist franchisors in the transition to the new guidelines, the agency also announced it would accept earnings claims prepared with either the old or new Item 19 guidelines until December 31, 1988, after which only the new UFOC Item 19 format would be authorized.

Franchise regulators in Indiana quickly followed the FTC in accepting the new Item 19 guidelines as the sole criteria governing earnings disclosure for purposes of state franchise registration. California and several other "registration" states also adopted the new standard. At the same time, seven of the thirteen states with registration requirements had either not taken action on the proposal nor were even considering such action.[79] New York and Minnesota were particularly critical of the new disclosure format, citing it as too lax and providing too much leeway for misleading earnings claims. Reports began circulating in mid-1988 suggesting that the two states might refuse to endorse the new guidelines.[80]

The situation provided new complications for franchisors who now complained of having entirely different earnings claim criteria in various states requiring development of two complete sets of disclosure information.[81] Responding to these complaints, FTC staff met on several occasions with NASAA and the recalcitrant state officials in an effort to secure uniform adoption of the Item 19 revisions by the January 1, 1989 deadline. As this deadline approached without action by two states, New York and Minnesota, franchisors faced an even more difficult predicament: if they followed the new Item 19 guidelines in these states they would violate state law; if they didn't they would violate federal law.

[78]FTC, Notice of Authorization for Franchisor Use of the Revised Uniform Franchise Offering Circular, *Federal Register*, June 15, 1987, p. 22686.

[79]Harold Brown, "The Numbers Game."

[80]Buck Brown, p. B1.

[81]Andrew C. Seldon, "The Seasons of Franchising," p. 22.

As the deadline passed without action by either state, rumors began circulating that the FTC would seek to impose the new rule nationwide, if necessary by preempting state franchise laws.[82]

The FTC delayed responding until February 16, 1989, when it published an "advance notice of proposed rule making" requesting public comments regarding "possible amendments" to the federal franchise rule's earnings claims and preemption provisions.[83] The agency's notice sought to focus comments on two questions: whether it should modify the earnings claims disclosure requirements of the franchise rule and whether it should change the rule's preemption standard. With regard to the second question, the FTC suggested several possible options, ranging from preemption of only those state earnings claims requirements that exceeded federal guidelines, to preemption of all state disclosure requirements. It also announced extension "until further notice" of the transition period for using both the old and new Item 19 disclosure formats.

The FTC's action was widely viewed as essentially "a turf battle between state regulators and the federal government." Among both franchisors and state regulators is was seen more as an elaborate prod to win state compliance than a serious threat to "essentially end the dual regulation that had characterized the franchising industry" for a decade.[84] The FTC had specifically rejected preemption less than two years earlier when, in response to similar complaints that the franchise rule had an adverse impact on smaller businesses, it ruled that "insufficient evidence" had been provided to warrant reevaluation of the agency's preemption policy."[85] Many franchisors believed political pressure from

[82]Buck Brown, "FTC May Lay Down Law on Earnings Claims," *Wall Street Journal*, February 6, 1989, p. B1.

[83]FTC, Advance Notice of Proposed Rulemaking and Extension of Time, *Federal Register*, February 16, 1989, pp. 7041-7045.

[84]Buck Brown, "FTC Proposes Limiting State Franchise Rules," *Wall Street Journal*, February 16, 1989, p. B1.

[85]FTC, Notice of Results of Regulatory Flexibility Act Review of the Franchise Rule, *Federal Register*, May 15, 1987, p. 18353.

states and franchisees would again deter preemption, while state regulators speculated that any broad preemption would also be rejected by the FTC as contrary to "the interest of consumers."[86]

Still, the FTC's notice held out some possibility that the FTC would preempt certain state earnings claims provisions, and this could set an important precedent for future preemption by the agency. This factor turned the FTC's request for comments into a broad referendum on the purposes and benefits of state regulation in franchising and generated a considerable number of detailed responses, particularly from franchisors. According to the IFA's legal counsel, franchisors intended to "do anything within our powers" to persuade the FTC to eliminate dual regulation.[87]

The responses received by the FTC followed largely predictable patterns, with franchisors, the American Bar Association and numerous franchise attorneys providing detailed summaries of "inconsistencies and conflicts" in federal and state disclosure requirements and generally calling on the FTC to consider broad preemption of all state franchising statutes. Franchisees and state regulators, on the other hand, focused largely on the preemption issue, expressing concern that preemption of state franchise laws would eliminate the only source of legal protections available to franchisees and would virtually wipe out the benefits gained from "over 100 years of composite state experience" in franchise regulation and enforcement.[88]

An unexpected aspect of the debate was the wavering position on preemption taken by the International Franchise Association. Having long advocated preemption to eliminate what it saw as "duplicative and conflicting" federal and state requirements, the IFA initially took a strong vocal position backing the preemption

[86]Buck Brown, "FTC Proposes Limiting State Franchise Rules," p. B1, and "FTC May Lay Down Law on Earnings Claims," p. B1.

[87]Neil Simon, cited in Buck Brown, "FTC Proposes Limiting State Franchise Rules," p. B1.

[88]Correspondence included in FTC Rulemaking File No. R511003. A brief summary of various viewpoints expressed in comments is provided by David J. Kaufmann, "The Franchise Debate," *Franchise and Business Opportunities 1990*, November 1989, p. 48.

options outlined in the FTC notice. The comments it submitted to the FTC in June, however, expressed only "lukewarm" support for these proposals.[89] The IFA recommended "some form of preemption" only if the burdens imposed by duplicative state requirements "cannot be mitigated through voluntary adjustments" between state and federal regulators. The association also hesitated in proposing specific changes in the franchise rule's earnings claims provisions, calling it "premature" for the FTC to change its rules "until greater experience had been obtained" with compliance under the revised Item 19 format.[90]

The uncertain position of the IFA reflected a growing debate among franchise attorneys regarding the potential benefits and likely consequences of federal preemption of state laws. Far from being the "panacea" many franchisors had anticipated, preemption was increasingly viewed as "a double-edged sword" that could bring as much harm as benefit for franchisors. In an article appearing in the Spring 1989 issue of the *Franchise Law Journal*, Washington D.C. franchise attorney H. Bret Lowell summarized these concerns, noting that preemption "may be too strong" and "may not cure the problems franchisors perceive in current franchise regulation." If registration laws are taken away, Lowell noted, states could be expected to substitute other forms of enforcement that might be "more onerous" and clearly "less palatable" to franchisors, including--

> provoking states to brandish their postsale enforcement weapons or to create private rights of action to enforce the federal standards, which would then be subject to the gloss of each state's courts.[91]

While reflecting a tactical uneasiness with preemption, the IFA's more conciliatory position also appears to have reflected a growing recognition among franchisors that earnings disclosure had become much easier under the revised Item 19 format and that, if encouraged, states might agree to make other desired changes in disclosure requirements. Among the few franchisors specifically commenting on the new Item 19 format, several noted the likelihood of "earnings claims use expanding because of the flexibility" provided to franchisors under the new approach; others estimated "the costs and effort in preparing information for the new Item 19 was substantially less" than under the old format.[92] The IFA's comments also conceded that the "revised Item [19] appears to have made it easier for franchisors to present earnings information to prospective franchisees." The remaining problem, according to the IFA, was New York's failure to formally adopt the revision, together with actions in other states that "have frustrated the liberalizing intent of the revision through state examiners' restrictive interpretations."[93]

If few franchisors specifically addressed the FTC's request for comments comparing the new and old Item 19 guidelines, even fewer responded to the agency's request for specific "evidence and comments" to document complaints that inconsistencies in state earnings disclosure requirements had added considerable cost to regulatory compliance and to the selling price of new franchises. While a number of respondents cited general figures representing "the range of costs" that franchisors can pay in preparing disclosure materials, only two provided specific figures for actual costs and the resulting effect on franchise sales. One respondent representing "a mid-sized business format franchisor" calculated that over $1,500 had been spent on compliance with disclosure requirements for each $15,900 franchise sold, representing almost 10 percent of what a franchisee must pay for a franchise opportunity.[94] The second franchisor reported having to invest hundreds of hours of work and $55,000 in legal bills to produce a final version of its disclosure materials, which resulted in

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[89]"Trade Group Lukewarm on Franchise Plan," *Wall Street Journal*, June 29, 1989, p. B1.

[90]William B. Cherkasky, p. 32 and p. 5.

[91]H. Bret Lowell, "The Preemption Mirage," *Franchise Law Journal*, Spring 1989, p. 26.

[92]John P. Moravek, p. 3; Michael Hill, p. 2.

[93]William B. Cherkasky, p. 4.

[94]Robert S. Harrison, Comments to FTC on Advance Notice of Proposed Rulemaking (File No. R511003) March 3, 1989, p. 1.

"increasing the cost of purchasing a franchise...from $17,500 to $25,000."[95]

Significant as these examples were, they represented costs of complying with all UFOC disclosure requirements, not just those involving earnings claims. They also failed to distinguish between costs that otherwise would have been required to meet UFOC guidelines and additional costs to meet state requirements. The absence of this type of detailed information, together with the lack of more generalized data from large numbers of franchisors showing high compliance costs, tended to confirm an opposite conclusion regarding earnings claims compliance that had been raised a year earlier in the Maryland study and had been expressed by spokesmen on both sides of the earnings claim issue.[96] According to the author of the Maryland study,

> Most written earnings claims made by franchisors are based on information that is readily available to them, such as their outlets' actual or average sales, costs and profits. Few, if any, claims are based on formal market studies. Therefore, although written earnings claims ...certainly require significant time and effort to prepare, they may not be as difficult or expensive to prepare as is generally believed.[97]

The absence of evidence substantiating substantial costs of compliance, together with franchisor and IFA comments that earnings claims had become easier and less costly to prepare under the new Item 19 format, tended to undermine arguments that changes were needed in the FTC's earnings claims guidelines. An additional action, acceptance by New York of the new Item 19 format, also appears to have eliminated any immediate justification for revisions in the agency's preemption policies. Minnesota had earlier initiated regulatory proceedings to revise it requirements to conform with the new disclosure format. New York's Attorney General used the opportunity of its formal comments to the FTC's

[95]Joseph F. DeGraw, Chairman, VCR Maintenance Corp., Comments to FTC on Advance Notice of Proposed Rulemaking (File No. R511003), May 5, 1989, p. 2.

[96]See, for example, H. Bret Lowell, p. 24; Harold Brown, "Pre-empting State Pre-Sale Disclosure Regulations".

[97]Warren Lewis, Earnings Claim Study, p. 17.

notice to announce that it had also issued a notice of proposed rulemaking to conform its earnings claims requirement to those of the revised Item 19 standard.[98]

Having achieved the uniformity on earnings claims standards it had sought, and lacking evidence showing substantial cost or inconvenience in state requirements and procedures, the FTC's Consumer Practices Division concluded that no basis had been found either to amend the franchise rule's earnings claim provisions or to justify preemption of state requirements on earnings claims or any broader issue. The Division's initial recommendations, forwarded to the Commission's Deputy Director in January 1989, contained these conclusions and urged that the notice record remain open in order to obtain continuing information regarding earnings claims compliance under the revised Item 19 format.[99]

The recommendations of FTC staff reflected the viewpoint expressed in the IFA's comments that existing experience with disclosure under the new Item 19 format had been insufficient and greater experience and additional study were needed prior to considering amendments to the franchise rule standards in this area.[100] At the same time, it incorporated the conclusion of a number of respondents on both sides of the issue who noted that the major points at issue between federal and state regulators were not "irreconcilable" and could be resolved with "a little time for due deliberations" between the FTC, NASAA and the various state agencies. "The better course is to continue NASAA and FTC attempts to work out inconsistencies and conflicts," suggested the counsel for a real estate franchisor, since this "cooperation would lead to a more comprehensive regulatory scheme using the strengths of both."[101]

[98]Alice McInerney, Assistant Attorney General in Charge, Comments to FTC Advance Notice of Proposed Rulemaking (File No. R511003), June 16, 1989, p. 1.

[99]As of August 1989 these recommendations had not received formal action by the Commission.

[100]William B. Cherkasky, p. 5.

[101]John P. Moravek, p. 15.

The apparent retreat of all parties from a confrontation over preemption illustrates the growing recognition that eliminating state disclosure requirements may be not only counterproductive, but may not even address the principal sources of franchisor complaints with inconsistency in state regulation. Most of these complaints involve provisions in state franchise laws which the FTC did not proposed to address through preemption--the so-called "relationship" provisions that regulate aspects of the ongoing relationship between franchisors and franchisees. Since these provisions require substantive changes in the terms and conditions of franchise agreements to recognize rights and protections for franchisees, they can also require extensive changes in disclosure materials. "In short, as long as relationship laws exist," notes one franchise attorney,

> disclosure documents will vary from state to state. Differing disclosure obligations will arise even though the UFOC standard in each state is nominally the same.
>
> To a less degree, differences in disclosure documents also result from regulation designed to supplement the UFOC Guidelines.[102]

[102] H. Bret Lowell, p. 24.

III. Issues of Franchise Relations

A. General

Current regulatory efforts seek to remedy the serious "imbalance" of information between franchisors and potential franchisees in solicitations and sales of franchises. An equally serious imbalance of power exists between these parties after the franchise agreement is initiated and throughout the ongoing relationship. Advantages of financial strength, access to information and to legal advice create a gross disparity of bargaining power in favor of the franchisor that results in one-sided franchise agreements that are offered, and generally accepted, on a take-it-or-leave-it basis. Throughout the relationship, the franchisor's ability to terminate a franchise, and with it a franchisee's investment and potential livelihood, can easily become an ability to dictate or coerce behavior and compliance. Even after a franchise is terminated, the franchisee remains at a serious legal and financial disadvantage in attempting to seek redress in court.

This imbalance of power in franchise relations is often dismissed with arguments that franchisees freely and knowingly enter into franchise arrangements and, if injured, have ample opportunity to seek legal compensation under principles of contract law, torts and trade regulation law. But franchisees have often found themselves without legal standing under contract or trade regulation laws, or barred from pursuing a grievance by their prior acceptance of contract provisions sanctioning actions they wish to contest. There exists no federal statute or consistent body of federal case law which recognizes or defines the legal rights of franchisees within franchise arrangements.

To a significant degree, the franchise agreement defines the legal as well as the operational standing of the franchisee. In recognition of the need for uniformity, efficiency, and control, franchise agreements have become highly standardized contracts. There is generally little opportunity to negotiate or alter

contract provisions or requirements, particularly for first-time franchisees. A number of potentially disadvantageous provisions have been incorporated in the agreements of most franchisors. These include: (1) a unilateral right of the franchisor to terminate a franchise agreement with or without cause; (2) a reservation by the franchisor of the right to refuse to renew a franchise agreement for any reason; (3) a requirement of prior approval by the franchisor of the sale or transfer of a franchise and reservation of the right to withhold such approval for any reason; (4) a right of the franchisor to recover a franchise, including any property, supplies, and equipment associated with the franchise, in the event of termination or non-renewal; and (5) a requirement that, upon termination, a franchisee may not compete in a similar business within a 50-mile radius for a 2-year period.

Any combination of these contract provisions can have dire consequences for franchisees. A franchisee may have spent years building a successful business only to find, often with only 30-days notice, that his franchise is being terminated, or will not be renewed. The franchisor is entitled to take over the franchise, either to operate or resell under more lucrative terms. The franchisee is not entitled to any refund of his initial investment or accumulated equity in the franchise, nor is there opportunity to sell the franchise to recover part of this investment. The franchisee loses not only his business and accumulated equity, but may also be barred under a noncompetition agreement from using the skills and goodwill he has developed to open another business.

Such events have occurred and can occur in any franchise system. The fact that they are not more commonplace depends as much on the goodwill of franchisors as on any rights or protections available to franchisees. Inherent in practically every franchise agreement is the potential for significant abuse of the interests of franchisees.

B. State Franchisee Fairness Laws

The significant imbalance of power inherent in franchise

agreements is justified with a variety of economic and legal arguments. At the heart of these arguments is the strongly held view that a franchise system is the product of the ideas, investment, and efforts of the franchisor. The desirability of a specific franchise opportunity is a reflection of the effort and success of the franchisor and the recognition gained by the franchisor's tradename and products. A franchisee makes a voluntary decision to join a franchise system for the purpose of benefiting materially from association with the franchisor's trade names and business format. The franchise agreement provides the legal basis for extending these benefits to the franchisee, while protecting the vital interests and investment of the franchisor. From this perspective, the continued success of the franchise system dictates that the interests of the franchisor and the franchise agreement provide the sole standards governing all operations, including franchise renewals and terminations.

On the other hand, the decision to join a franchise system as a franchisee requires payment of an initial franchise fee and additional investment to establish the franchise. These investments constitute the risk capital of the franchisee. The ability of franchisees to build upon this initial investment depends not only on their own efforts, but on the degree to which the franchisor's operating system encourages or stifles individual initiative and entrepreneurism. Where these efforts are successful, the franchise becomes a valuable capital asset for the franchisee. The realization of such value, however, remains wholly dependent upon the franchisor's power to renew, terminate or permit sale or transfer. The protection and realization of the capital value of the franchise thus become a vital interest for which the franchisee seeks appropriate legal and regulatory protection.

These conflicting interests of franchisors and franchisees have become the principal issue in franchise relations and the focus of an increasing body of state franchise relationship or "fairness" legislation. This legislation has sought to intervene in franchise relationships to moderate the one-sided nature of

franchise agreements and provide recognition and fair treatment of the legitimate financial interests of franchisees.

Franchise fairness provisions first appeared in federal legislation in the Automobile Dealer Franchise Act of 1956, the various franchise practices acts introduced in Congress in the 1960s, and the Federal Petroleum Marketing Practice Act of 1968.[103] The failure of Congress to enact any fairness provisions covering franchises generally prompted a number of states to enact franchise relationship legislation, beginning with Delaware in 1970. A total of seventeen states have adopted such legislation, seven states enacting only franchise relationship statutes, and ten "regulating" states adopting relationship provisions either in conjunction with, or in addition to, broader franchise disclosure and registration statutes.[104]

The seventeen state franchise statutes incorporate provisions which range from a general prescription of "fairness" and "good faith" in the conduct of franchise operations, to detailed enumeration of prohibited or permitted actions defining good faith or "good cause" in specific circumstances. The activities or circumstances most commonly addressed in fairness statutes and legislation include: conditions permitting franchise termination or nonrenewal, prohibition of certain purchase requirements, minimum requirements for the duration of franchise agreements, prohibition of specific acts not necessary for the conduct of business, minimum notification for termination or renewal, and creation of a duty of franchisors upon termination of a franchise to repurchase certain equipment or reimburse a franchisee for some part of the value of a franchise.

Since such provisions require changes in the substantive terms of a franchise agreement, they are perceived as striking at the fundamental interests and authority of franchisors and are strongly resisted. Franchisors incorporate such provisions in franchise agreements only where mandated by state law. This necessitates revisions in standard franchise agreements and disclosure documents to correspond to specific requirements in each of the seventeen states.[105] The complaints expressed by franchisors over the burdens of having to prepare "upwards of eighteen different disclosure documents" thus derive to a larger extent from the franchisors' own determination to avoid incorporation of fairness provisions in franchise contracts wherever possible than from any inconsistencies in state disclosure requirements.[106]

Franchisors also have vigorously opposed any efforts to enact new franchise relationship laws or strengthen the seventeen existing laws. The International Franchise Association (IFA), an association of the major business format franchisors, argues that such measures are unnecessary since the market place will encourage franchisors to "exercise prudence" and will "eliminate unfair relationships."[107] The Association has had a significant degree of success in defeating such legislation throughout the country. In 1987, for example, IFA's president boasted of a "1000 batting average" in defeating some twenty-seven major "anti-franchising measures" which had been introduced in twenty states.[108] The IFA's target list of legislation for that year included few business regulation, tax or other measures that might adversely affect franchise operations, raise costs or even affect sales of franchise businesses. Rather, the large majority of these anti-franchising proposals involved issues relating to contractual relations between

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[103]See notes 27 and 125.

[104]Arkansas, Connecticut, Delaware, Mississippi, Missouri, Nebraska, and New Jersey have fairness statutes only. The ten states having both fairness statutes and franchise disclosure/registration statutes include: California, Hawaii, Illinois, Indiana, Michigan, Minnesota, Virginia, South Dakota, Washington, and Wisconsin.

[105]H. Bret Lowell, p. 24.

[106]"In short, as long as relationship laws exist, disclosure documents will vary from state to state...To a lesser degree, differences in disclosure documents result from regulation designed to supplement the UFOC guidelines." H. Bret Lowell, p. 24.

[107]William Cherkasky, pp. 4-5, 29.

[108]Charles Bernstein, "Dangerous Portrayal: Franchising's Rosy Scenario," *Nation's Restaurant News*, March 7, 1988, p. 7. See also, Richard T. Ashman, *1987 Annual Report*, International Franchise Association, p.1.

franchisors and franchisees, with over half seeking to define the circumstances in which franchisors may terminate, refuse to renew, or refuse to permit the sale of a franchise.[109]

The prevalence of the view among franchisors that all efforts to protect the legitimate financial interests of franchisees are "anti-franchising," reflects the embattled state of relations between franchisors and franchisees generally. It also illustrates the determination with which franchisors will continue to reject any basic legal protections for the financial interests of franchisees in the absence of uniform or national statutory requirements.

c. Principles of Good Faith and Fair Dealing

Although franchisors tend to view franchise relations exclusively from the perspective of private contractual arrangements, such relations are not immune from equitable principles of law established in public policy and contract law. Such principles are generally expressed in statements requiring fair dealing and good faith in contract performance. These principles are generally understood to create specific rights and duties not made explicit in a contract and to limit the scope or the exercise of rights and duties included in the letter of a contract.

State statutes and court decisions have generally recognized that a "community of interests" exists among franchisors and franchisees under which the continued viability of a franchise system is generally given precedence over contending positions that can jeopardize its operation. While this tends to uphold decisions and actions of the franchisor, as the founder and authority in franchise arrangements, it is also interpreted to impose a duty of good faith and fair dealing on both parties.[110] This duty is

[109]See, for example, *IFA State Legislative Update*, International Franchise Association, September/October 1987.

[110]A number of state statutes identify a "community of interest" between franchisor and franchisee as a definitional element of a franchise relationship, including the Hawaii Franchise Investment Law, the Washington Franchise Protections

understood within the context of its application to commercial transactions generally, under the Uniform Commercial Code, as requiring observance of reasonable commercial standards of fair dealing in the performance of enforcement of a contract.[111]

The breadth of the good faith principle permits its application to many facets of the relationship between a franchisor and franchisee. Since franchise contracts are drafted by, and with particular concern for the interests of the franchisor, this principle applies clearly to limit contract rights exercised by the franchisor, particularly with regard to actions that threaten the financial interests of franchisees. However, the concept of a "community of interests" within franchise arrangements also requires application to the performance of franchisees. Thus a franchisee's underreporting sales for purposes of determining royalty payments would illustrate a lack of good faith in much the same manner as a franchisor's imposing unreasonable investment or fee requirements to discourage renewal of a successful franchise.

Specific application of the principle of good faith and fair dealing to franchise arrangements was provided in the Automobile Dealer Franchise Act of 1956. Congress not only defined this principle for the first time in statute, but affirmed the bilateral nature of its obligations upon both franchisors and franchisees. The Act defines the term "good faith" as meaning

> the duty of each part to any franchise,...to act in a fair and equitable manner toward each other so as to guarantee the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party: *Provided*, that recommendation, endorsement, exposition, persuasion, urging or argument shall not be deemed to constitute a lack of good faith.[112]

Act, the Wisconsin Fair Dealership Law, the Minnesota Franchise Act and the New Jersey Franchise Protection Act.

[111]General legal principles of good faith and fair dealing are well developed, with case citations, in Ernest A. Braun, pp. 156-237.

[112]Automobile Dealers Franchise Act of 1956 (also called the Federal Automobile Dealer Day-in-Court Act), 15 U.S.C. 1221(e).

The specific wording of the Act may have been unfortunate in that its good faith standard, although broadly intended, has been narrowly interpreted as prohibiting only actions involving coercion or intimidation. A wrongful or arbitrary demand, if not backed by coercive sanctions, has not been generally considered a violation.

Federal courts have tended to limit the application of this weakened good faith standard only to automobile franchises. Although the Act defined a franchise in broad terms, and automobile dealers constituted a significant portion of all franchises in 1956, the courts have been reluctant to interpret the Act as implying that Congress recognized a good faith standard applicable to all franchise arrangements. The trend in court decisions in this area has been one of refusing to recognize or create obligations that are not present in the franchise agreement, such as good faith principles, unless there exists a specific basis for such obligations in federal or state statutes.[113]

Similar difficulties have emerged in applying the generally recognized principles of good faith and fair dealing of the Uniform Commercial Code to franchise arrangements. The Code has been generally interpreted as applying to merchants dealing with one another in commercial transactions. Since many courts have not considered franchise arrangements to be characteristic of the usual "supplier-purchaser" relationship between merchants, there has been wide inconsistency in the application of the good faith standard of the Code to the parties of franchise arrangements.[114]

The recent trend in federal court rulings has been one of recognizing that an implicit standard of good faith and fair dealing exists in franchise agreements, but that the principle applies only where a franchise agreement is silent or ambiguous. Thus an increasing number of cases brought by franchisees against

[113]Among more recent cases establishing this precedent see: *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2nd 129 (5th Cir. 1979) and *Gianelli Distributing Co. v. Beck & Co.*, 215 Cal. Rptr. 667 (1985).

[114]Harold Brown, "Private Remedies," *New York Law Journal*, December 22,1989; also Statement on NASAA's Proposed Model Franchise Investment Act, March 2, 1990.

actions claimed to violate good faith principles have been rejected by courts on grounds that the applicable franchise agreements were "definite and unambiguous" in permitting the contested actions.[115] One recent decision has narrowed application of the good faith standard still further by determining that unless there is evidence that a party acted in bad faith in negotiating the original franchise agreement, a good faith standard cannot be applied to contest any subsequent actions permitted by such agreement.[116]

Given such decisions, the principle of good faith and fair dealing, broadly recognized in all commercial transactions, continues to be debated and denied within franchise arrangements. The seventeen state fairness statutes have sought to remedy this by incorporating provisions clarifying that an obligation of good faith and fair dealing applies within all franchise arrangements. But these provisions are inconsistent and range from broad statements of principle to detailed descriptions of prescribed actions.

Recent efforts to promote uniformity in franchise regulation have taken divergent approaches in recognizing good faith obligations. NCCUSL's Uniform Franchise Act proposes essentially a codification of current federal court interpretation by recognizing that a franchise agreement "imposes on the parties a duty of good faith in its performance and enforcement," but restricting its application where it might "add to or override substantive provisions of a (franchise) contract."[117] NASAA's Model Franchise Investment Act also recognizes that the parties in a franchise arrangement have a good faith obligation (defined as meaning "honesty in fact and observance of reasonable standards of fair dealing in the franchise relationship"), but does not limit

[115]See for example: *Rosenberg v. Pillsbury Co.* (S.D.N.Y. 1989); *Flint Davis v. Sears, Roebuch and Co.*, (6th Cir. 1989); *Faltings v. International Business Machines Corp.*, (4th Cir. 1989).

[116]*Cloverdale Equipment Co. v. Siomon Aerials, Inc.* (6th Cir. 1989).

[117]Uniform Franchise and Business Opportunities Act, Section 201.

its application. The Act grants courts the authority to refuse to enforce unconscionable contract provisions, identifies fraudulent and prohibited acts and enumerates "good cause" standards for purposes of franchise termination and nonrenewal.[118]

D. Franchisee Right of Action

While franchisors argue that franchisees have ample opportunity to seek remedies under existing federal and state laws, franchisees have found such opportunity to be restricted generally and extremely inconsistent from one state to another. There exists no federal statute or consistent body of federal case law that recognizes or defines the legal rights of franchisees within franchise relationships. In seeking to pursue legal claims against franchisors, franchisees are generally handicapped by having to overcome strong estoppel arguments arising from prior acceptance of unfavorable contract provisions and by an inability to invoke recognized principles of good faith and fair dealing applicable to all other commercial relationships. But even before confronting these problems, franchisees often face considerable difficulty in establishing a legal basis for initiating legal actions against franchisors.

A substantial portion of the complaints brought by franchisees against alleged misrepresentations or nonperformance by franchisors arise from actions or statements made during the solicitation and sale of a franchise. But where such actions constitute clear violations of FTC disclosure procedures, a franchisee may have no clear basis on which to seek remedy in federal court. In publishing guidelines for its franchise disclosure rule, the FTC provided policy statements recognizing that a federal right of action existed for franchisees, or for potential franchisees, who suffer loss due to violations of the rule.[119] And while the FTC's

[118]Model Franchise Investment Act (July 17, 1989 draft), Section 20 (good faith standards), Section 21 (fraudulent acts), Sections 15-18 (termination, renewal, transfers).

[119]Final Interpretive Guides, p. 49971.

statement also declared that such a right was *necessary* for adequate enforcement of the rule, the federal courts have consistently denied that such a right exists. Except in a single instance, every federal district and appellate court decision has refused to recognize a direct or implied right of action under either the franchise rule or the FTC Act.[120]

The rule enforcement scheme envisioned by the FTC has suffered from the absence of specific authorization in federal statute. As with court interpretation of implied good faith principles, the federal courts have consistently refused to recognize, or to create, remedial rights or procedures where none exists in statute. In contrast, a right of action was specifically authorized in the Securities Act of 1933 which authorizes similar federal disclosure requirements for investment securities.[121] This right of action is broadly stated to apply to any misrepresentation or omission in a disclosure document and has broad application to all officers, directors, staff and agents involved in the preparation of such documents. Efforts to define franchise offerings as securities for purposes of applying this broad right of action to allegations of franchise fraud have generally failed. Prevailing court opinion has limited the application of securities law to investments, unlike a franchise, where a purchaser has little or no direct participation in the conduct of business.[122]

Congress did provide a right of action for automobile franchises in the Automobile Dealer Franchise Act of 1956. This right is broadly stated to permit actions to recover damages and court costs relating to any failure of an automobile manufacturer "to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling

[120]Harold Brown. "Pre-empting State Pre-Sale Disclosure Regulations."

[121]Securities Act of 1933, 15 U.S.C. 77k.

[122]A discussion of efforts to classify franchises as securities, with a listing of major cases, is provided by Ernest A. Braun, "Policy Issues of Franchising," pp. 194-196.

or not renewing the franchise..."[123] A more limited right was provided for gasoline franchisees in the Petroleum Marketing Practices Act of 1968 relating to any failure by a franchisor to comply with appropriate requirements relating to termination or renewal of a franchise.[124] Although legislation was introduced in successive sessions of Congress from the late 1960s through the 1970s seeking to extend to all franchisees a legal right of action based upon the broader provisions of the 1956 Act, this legislation was never enacted into law.[125]

In the absence of broad remedial rights at the federal level, state legislatures have sought to provide franchisees with a legal basis to bring actions against franchisors under state franchise disclosure, unfair trade practices, industry relationships and franchise fairness statutes. All fifteen state franchise disclosure statutes provide some form of private enforcement rights for franchisees and potential investors. Ten of these states also provide franchisees with additional basis for legal action in franchise relationship statutes or provisions.[126] An additional six states and the District of Columbia provide a right of action involving violations of state franchise fairness laws, while four states have applicable private enforcement provisions in broader business disclosure laws.[127] Industry relationship laws enacted in most states also provide a basis for legal action for specific groups of franchisees (e.g., automobile, gasoline, farm equipment dealers).

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[123] 15 U.S.C. 1221.

[124] Petroleum Marketing Practices Act of 1968, 15 U.S.C. 2805(a).

[125] The Franchise Distribution Act of 1967 (S. 2507, 90th Cong.); Fairness in Franchising Act of 1969 (S. 1967, 91st Cong.); Franchising Practices Reform Act (H.R. 8349, 94th Cong.) (H.R. 5016, 95th Cong.); Franchise Reform Act (H.R. 2305, 96th Cong.).

[126] See note 104.

[127] Arkansas, Connecticut, Delaware, Nebraska, New Jersey, Missouri and the District of Columbia have enacted franchise relationships/practices legislation; Ohio, Oklahoma, Texas and Utah have incorporated applicable enforcement rights in broader business disclosure statutes.

Fourteen states have also incorporated a private right of action in "Little FTC Acts" prohibiting unfair or deceptive practices in trade and commerce. Modeled after section 5(a) of the federal FTC Act,[128] the little FTC acts have tended to be particularly strict in prohibiting "deceptive" acts and have defined the term broadly enough to make it easier to prove deception than under common law principles. As a result, in states where no private cause of action is available to franchisees, these acts have become the principal vehicle for pursuing complaints against franchisors involving franchise fraud, unfair terminations, anti-competitive conduct and other actions.[129]

Taken together, these statutes provide franchisees with some statutorily defined basis for legal action in a majority of states. But franchisees have a broadly defined right of action applying to both franchise sales and operations in less than one-fourth of the states. In the remaining states, the remedial rights available to franchisees tend to be extremely limited, applying only to specific disclosure procedures, specific violations in franchise practices laws or specific groups of franchisees.

Recent national efforts to encourage uniformity in state franchise regulation have both sought to provide for private legal actions by franchisees. Where NCCUSL's proposed Uniform Franchise Act would permit actions to recover damages for violations principally of disclosure requirements, NASAA's Model Franchise Act would permit suits for damages incurred "in connection with the purchase and cperation of a franchise."[130] NASAA's draft proposal also incorporates language modeled on securities law that would extend liability for injuries incurred by franchisees, or b

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[128] 15 USC 45(a).

[129] Discussion of recent use of Little FTC Acts by franchisees, see Harold Brown, "Policy vs Contract," *New York Law Journal*, April 26, 1988; L.S. Stadfeld & R.B. Spandorf, "Recent Rulings Under State Little FTC Acts of interest to Franchisees and Franchisors," *Franchise Law Journal*, Spring 1989; Harold Brown, "Pre-empting State Pre-Sale Disclosure Regulations."

[130] Uniform Franchise and Business Opportunities Act (NCCUSL) section 506; Model Franchise Act (NASAA), section 25.

potential franchisees, to all officers, directors, employees or agents directly or indirectly involved in a violation of the act.

E. Contractual Limitations on Due Process

Even where a right of action may be clearly established in state law, a franchisee can be frustrated in exercising that right or in seeking judicial remedies by a number of procedural devices which franchisors often incorporate in franchise agreements. Foremost among these is the practice of requiring franchisees to agree at the initiation of a franchise to so-called "choice of venue" and "choice of law" provisions which stipulate the laws, courts and jurisdiction that will govern all disputes arising under the agreement. In most instances, this involves agreement that all disputes will be settled in the jurisdiction of the franchisor's "operating locale" and under the laws of the franchisor's home state.[131]

While justified as necessary for maintaining uniformity within a franchise system, and seemingly harmless on paper, contractual choice of law and venue requirements can be extremely detrimental to franchisees who seek to initiate legal actions against a franchisor. These provisions virtually guarantee that any legal proceeding will be undertaken in a jurisdiction that is distant and inconvenient for the franchisee and under laws that are more favorable for the franchisor. In some instances, franchisees have found that the applicable law or jurisdiction effectively bars them from legal actions by denying legal standing to non-residents.[132] Of equal significance from a policy perspective is the use of contractual choice of law and venue provisions by franchisors to circumvent the due process guarantees provided franchisees in the laws of other states and to avoid liability or prosecution in jurisdictions where specific contract provisions or actions may be

[131]Michael C. Hill, p. 9.

[132]Harold Brown, "'Haagen-Dazs' and Sanctity of Contract," *New York Law Journal*, November 14, 1989.

violations of the law.[133]

A number of additional procedural devices have been included in franchise contracts that have the effect of shielding franchisors from possible legal action or limiting the ability of franchisees to obtain relief in such actions. These include so-called "integration" clauses which preclude from subsequent litigation any fraud or deception that may have preceded the execution of the franchise contract; "hold harmless" provisions requiring franchisees to agree to a prior waiver or release of a franchisor from specific acts or violations of state laws; contractual provisions limiting or precluding relief under specific statutes and agreements limiting the franchisee's right to injunctions and other forms of equitable relief.[134]

Another device that has become the focus of increasing controversy involves contractual provisions requiring arbitration of all issues arising under a franchise agreement. Arbitration of franchising disputes has increased nearly five fold since 1981, according to the American Arbitration Association, due largely to increasing use of out-of-court resolution requirements in franchise contracts.[135] Franchisors tend to view arbitration not only as faster and less expensive than court actions in resolving disputes, but also as a means of avoiding possible litigated recovery by franchisees, particularly where there is a possibility of multiple damages and large fee allowances. Arbitration also permits less public scrutiny of internal disputes that could be potentially damaging to the sale of new franchises.[136]

Where properly structured with impartial arbitrators, an

[133]Harold Brown, "Private Remedies: State Pre-Sale Disclosure Rules."

[134]These and additional contract provisions are noted in: Andrew J. Sherman, "Structuring Advantageous Franchise Agreements," *Business Age*, Vol. 2, No. 3, p. 27. Harold Brown, "'Haagen Dazs' and Sanctity of Contract."

[135]"Arbitration Cases Soar in Franchising Industry," *Wall Street Journal*, July 25, 1990, B1.

[136]Harold Brown, "Observations on Alternative Dispute Resolution," *New York Law Journal*, June 14, 1989.

arbitration proceeding can provide timely and effective resolution of many issues arising within a franchise relationship. But arbitration may be inappropriate, and even abusive, when required for all disputes between parties in a franchise, especially those involving terminations and renewals. Some franchisors have also sought to incorporate additional requirements in franchise agreements that are intended to weaken the arbitration process or discourage its use by franchisees. These include restricting the use of qualified arbitrators, requiring arbitration at the franchisor's home office, precluding access to all provable direct or consequential damages and/or punitive damages, and requiring payment of arbitration fees that grossly exceed actual costs or comparable costs of litigation.[137] Requiring franchisees to agree in advance to arbitration of all matters, or to accept arbitration with numerous restrictions, has been described as "tantamount to a contractual forfeiture of resort to all judicial process."[138]

A number of states have adopted provisions in franchise relationship statutes that prohibit or nullify contractual provisions intended to deny due process or inhibit the exercise of legal rights by franchisees. Seven states have similar provisions prohibiting contractual requirements that franchisees agree in advance to any "release, assignment, novation, waiver, or estoppel which purports to relieve any person from liability" imposed under provisions of state law.[139] Three states include general prohibitions against actions that limit the exercise of legal rights or restrict litigation in any manner, while two states have enacted prohibitions to nullify certain contractual choice of law and choice of venue requirements.[140] Four states and the District

[137]Harold Brown, Letter to the House Small Business Committee, March 9, 1990, p. 8.

[138]Harold Brown, "Observation on Alternative Dispute Resolution."

[139]Arkansas, Hawaii, Indiana, Michigan, Nebraska, New Jersey and Washington.

[140]Indiana, Michigan and Virginia have provisions nullifying actions that limit exercise of legal rights or limit litigation; Michigan law prohibits required litigation outside the state and Minnesota law nullifies choice of law provisions that have the

of Columbia also have enacted various provisions limiting the circumstances in which arbitration can be required in franchise agreements or employed in resolving franchise disputes.[141]

Several recommendations in NASAA's Model Franchise Investment Act are also intended to address contractual restrictions on the exercise of legal rights by franchisees. Section 12 of the Act would nullify contractual provisions which restrict jurisdiction or venue to a forum outside a state for any claim that would otherwise be enforceable under that state's laws. Section 13 would nullify any provisions requiring franchisees to agree in advance to waive any right or to relieve a person of any duty or liability provided in the statute. The Act would also nullify integration clauses in franchise agreements, stating that such provisions do not remove from judicial review any statements, misrepresentations or actions that violate the law.[142]

F. Franchise Terminations, Renewals, and Transfer

The dominant problem arising between franchisors and franchisees, and the one for which the principle of good faith and fair dealing is most commonly invoked, involves the conditions giving rise to the severance of a franchise relationship. This is perhaps the most crucial issue for franchisees, whose livelihood and capital investment in a franchise are clearly dependent upon the franchisor's power to terminate, to decline to renew, or to deny the franchisee the right to sell or transfer a franchise. Franchisees have sought legal and legislative protection to prevent arbitrary or abusive exercise of this power. On the franchisor's side, it is believed that such power is essential to the efficient operation of a franchise system. Legal actions designed to restrict this authority, or to guarantee franchise renewals, are

effect of waiving compliance with provisions of state law.

[141]California, Indiana, Michigan, Wisconsin, District of Columbia.

[142]NASAA's Model Franchise Investment Act, June 15, 1990 draft.

widely viewed by franchisors as tantamount to sanctioning noncompliance, incompetence and uncompetitiveness.

Every franchise agreement contains elaborate provisions outlining the franchisor's authority regarding termination of the franchise. This authority provides the franchisor with the most effective instrument for enforcing compliance with the franchise agreement. The franchisor and franchisee are both aware of the consequences of termination and this knowledge permeates their entire relationship. Whatever contractual advantage the franchisor enjoys at the outset of the relationship becomes augmented over time, since franchisees will have more invested in their franchises and thus more at risk if the franchise is terminated. The leverage gained by a franchisor can often translate into the power to intimidate and coerce behavior that may not be required or sanctioned under the franchise agreement.

In order to avoid the implicit "threat" of termination, franchisees feel compelled to comply with all directives and instructions of the franchisor, no matter how unreasonable, invalid or arbitrary they may be. Most prevalent forms of abuse in this regard involve: required purchases of inventory and equipment from the franchisor at above market prices; required testing of unproven products without allowance for potential loss; required investment to alter the design or appearance of the franchise location; "voluntary" contributions for special promotional campaigns; alteration of exclusive marketing or territorial rights; and extension of non-competition agreements to apply to franchise operations or to unrelated business activities of franchisees.

Franchisees face an equally difficult and inevitable problem of franchise renewal with the knowledge that any lack of cooperation in these areas can also produce a challenge to renewal of the franchise. The equity built by the franchisee during the ten or twenty-year term of the franchise is fully at risk at this point, as franchisors generally have few restrictions on their freedom to accept or reject renewal. A franchisee who has complied with all directives may still be confronted with burdensome

requirements or significant increases in fees as conditions for franchise renewal. And like the original franchise agreement that must be accepted on a take-it-or-leave-it basis, the franchisee may have little option but to accept renewal on whatever terms the franchisor offers.

From this perspective, abuses related to nonrenewal of franchises may be more serious and more pervasive than franchise terminations, since they occur at the close of the contract term and are far more difficult to document or contest as violations either of a franchise contract or good faith principles.

Equally difficult to document are abuses involving a refusal to permit the sale of transfer of a franchise. At any time during a franchise relationship, a franchisee may die, become disabled, or decide to sell or transfer a franchise. Franchisors have a valid interest in assessing the capabilities and general acceptability of any individual seeking to take over the franchise. This valid interest can translate into abuse, however, where delay in providing approval, or repeated rejection of potential buyers, have the effect of undermining a franchisee's ability to sell a franchise, delaying a sale beyond the expiration of the franchise term, or depressing the price of a franchise and the potential return to the franchisee. Withholding approval of the sale or transfer of a franchise can provide a franchisor with an effective method of punishing a disgruntled franchisee or for obtaining a valuable business asset at a depressed price.

Numerous examples of abusive conduct relating to franchise terminations, renewals and transfers have been documented in published articles and public records. What is not always apparent in such documentation, however, is the degree to which apparent abuses may have partial justification in actions or failures of franchisees. A franchisee may have failed to transact business sufficiently well to meet competition, or may have consistently fell short of meeting sales quotas. Where, in fact, a franchisee fails to promote products adequately or refuses to provide required services to customers, a franchisor may have legal justification

in to terminate or refuse to renew the franchise.

What constitutes a justifiable termination or nonrenewal is extremely difficult to determine and varies considerably depending on one's perspective. Franchisors and their representatives tend to minimize the occurrence of terminations and nonrenewals generally, while attributing most of those that do occur to nonperformance or abusive conduct by franchisees. In arguing against the need for legal protection in these areas, franchisors frequently cite Commerce Department data showing, for example, that only three percent (7,335 franchisees) of all franchisees operating in 1986 were terminated, and that only seven percent (909 franchises) out of some 13,000 franchise agreements up for renewal during that year were not renewed. Of the franchises terminated or not renewed, these figures claim, "a clear majority were at the initiative of the franchisee or by mutual consent."[143]

The problem with this often cited data is that it is, at best, misleading and inadequate. What is generally not explained about the information is that it does not derive from any independent assessment by a government agency, but from surveys of franchisors who choose to respond. Those responding are generally the more successful among the larger franchise chains included in these surveys, not the newer or troubled franchise systems that generate a large portion of franchisee complaints.[144] Even among more successful franchisors, however, an understandable concern with franchise sales will often discourage voluntary reporting of information that presents an unfavorable or contentious image of the franchise system.

The survey data also fails to provide essential qualitative information about the terms under which franchises are continued or terminated. Whether, for example, franchisees are forced to accept unfavorable conditions to gain renewal or deter termination, whether abuses or intimidation by the franchisor prompted

[143]*Franchising in the Economy 1986-1987*, p. 14.

[144]Kathryn L. Boe, Hearing on Unfair Franchise Practices, p. 196.

franchisees to voluntarily withdraw, or whether "mutual consent" to end a franchise derived from a franchisee's refusal to accept unreasonable renewal conditions.[145]

Regardless of how it is documented, abuse in franchise terminations and renewals is perceived as serious enough to warrant some form of regulation by every state and the federal government. Most of this regulation derives from state industry relationships statutes which govern conditions permitting termination or cancellation of automobile dealerships, gasoline franchises and other specific types of franchises. A substantial number of these statutes incorporate generalized or undefined standards permitting termination or nonrenewal from "good cause," and prohibiting such actions where motivated by "bad faith."

At the federal level, the Petroleum Marketing Practices Act provides more detailed limitations for gasoline franchise terminations and nonrenewals. Under the Act, terminations and nonrenewals are permitted only with "good cause," which is limited to specific circumstances. These circumstances are sufficiently broad, however, to provide franchisors with considerable leeway in citing cause for action.[146] The Act is far more specific in defining procedures to be followed in terminating or refusing to renew a franchise, with the result that most successful claims brought under the Act involve violations of procedure rather than failure to establish good cause.

A number of the state franchise fairness statutes provide greater specificity in limiting the circumstances permitting terminations and nonrenewals. The California Franchise Relations Act outlines specific circumstances under which a franchise may be

[145]Commerce Department survey data suffer from additional inadequacies. For example, franchisors often do not report data on the failure or termination of a franchise if a franchise, meaning the physical unit, remains in operation despite failure or termination of one or more franchisees. "From the standpoint of the franchisee, this could very well be considered a business failure, whereas from the standpoint of Department of Commerce statistics it is not." Kathryn Boe, p. 196.

[146]55 U.S.C. Section 2802.

terminated.[147] In all other circumstances, termination would be prohibited without good cause and only after a franchisee is provided a 30-day notice period in which to correct problems or failures cited as cause for termination. The California statute also requires 180-day notice prior to any nonrenewal of a franchise, during which the franchisor must permit sale of the franchise to an acceptable purchaser. A franchisor is prohibited from cancelling a franchise for purposes of acquiring it or converting it to the franchisor's own use.

The Wisconsin franchise and dealership fairness statutes provide less detailed, but equally broad provisions prohibiting termination, cancellation, failure to renew and substantial alteration of the competitive circumstances of a franchise agreement without good cause. The statutes require a 60-day period in which to rectify any claimed deficiencies and places upon the franchisor the burden of proving good cause.[148] Critics cite the Wisconsin statutes as the "extreme" in franchise regulation, saying they have had the effect of limiting the number and type of franchises willing to do business in Wisconsin and thus have a detrimental impact on the citizens of the state.[149]

G. Seeking Balance in Regulatory Policy

Numerous approaches have been proposed in state legislation to provide greater protection to franchisees from arbitrary or abusive termination or cancellation of a franchise. The tendency in this area has been to provide solutions in the extremes--either by providing common, but vague standards of acceptable conduct, or to impose detailed limitations on a franchisor's exercise of enforcement powers. Both approaches have serious weaknesses.

On the one hand, franchisees face considerable disadvantage

[147]California statutes 1980 ch. 1355, sections 20000-20043.

[148]Fair Franchise Law, Wisconsin Statutes, 553.01-553.78 (1981-1982); Fair Dealership Law, Wisconsin Statutes, 135.01-135.07 (1987-1988).

[149]Michael C. Hill, p. 5.

in litigating under general good cause standards where they are severely limited by prior acceptance of contract terms and by difficulties in proving either bad faith or absence of cause. In the other extreme, statutory prohibitions may be so restrictive as to deprive a franchisor of the authority needed to prevent abusive or incompetent behavior by franchisees that can harm a franchise system.

The critical issue for regulation in this area is one of finding a balance between the right of franchisors to manage their franchise systems using their best business judgment, and the right of franchisees to receive the full rewards of their effort and investment. Regulation must seek to facilitate cancellation of a franchise wherever such action is warranted. The franchising relationship is one based on mutual trust and a shared desire to work together toward common goals. If this trust is missing, or if a "community of interests" no longer exists, the relationship is no longer beneficial to either party. At the same time, the termination and renewal processes must be monitored to pravent abuses. At a minimum, the process should permit franchisees who leave a franchise system, either by choice or cancellation, to be compensated for assets or losses, either by facilitating the sale of a franchise or requiring compensation for some part of the value of a franchise.

Four general policy objectives emerge as essential to developing regulatory policy that balances the interests of franchisors and franchisees in the critical areas of franchise termination, renewal and transfer. These center on the need--

1. to monitor the process of termination and renewal to limit abuse and permit cancellation only where undertaken with good cause and in conformity with franchise agreements;

2. to provide franchisees with sufficient notice and appropriate opportunity to correct failures or deficiencies cited as cause for such action;

3. to facilitate termination or non-renewal where cause exists and where deficiencies have not been corrected; and

4. to provide assurance to franchisees, that upon termination or cancellation, there is opportunity to recover some portion of the value of their investment in a franchise.

Of the current state fairness statutes, the California Franchise Relations Act is the most comprehensive in addressing all four policy objectives. The Act prohibits abusive acts, permits opportunity for franchisees to correct deficiencies and facilitates termination or nonrenewal where cause can be established. The Act also imposes several important requirements to assure compensation to franchisees: the required six-month notification period prior to nonrenewal during which a franchisor must permit sale of the franchise to a qualified buyer and a requirement that, upon termination or cancellation of an agreement, a franchisor must offer to repurchase all required inventory purchased by the franchisee at the lower of the fair wholesale value or the franchisee's original purchase price.

The Model Franchise Act of the North American Securities Administrators Association (NASAA) also addresses these four policy areas along a similar basis as the California statute.[150] The proposal differs principally in the requirement that a franchisor repurchase all remaining "goods and equipment" previously sold to the franchise at the most recent price charged franchisees.

A criticism of the approach incorporated in the California statute, and carried over into the NASAA Model Act, is that the repurchase requirements are excessive and unnecessary. Advocates for franchisees, on the other hand, consider these provisions as inadequate either for compensating a franchisee for his investment in a franchise or for discouraging abusive actions by franchisors. The temptation for abuse would remain since much of the business value of the franchise would still be expropriated by the franchisor.[151]

[150]Provisions refer to the fairness provisions incorporated in Section 15-18 of NASAA's July 17, 1989 draft.

[151]Barry Kellman, written testimony, Hearing on Unfair Franchise Practices, p. 187-188.

An alternative approach was incorporated in legislation introduced in the Senate in the late 1960s that would require franchisors to purchase a terminated or cancelled franchise from the franchisee for an amount equal to the appraised fair market value of the franchise. The fair market value would include goodwill and the reasonable value of customer's accounts that would be preempted by the franchisor.[152] Advocates of this approach maintain that the cost involved in terminations and nonrenewals would force franchisors to carefully assess each cancellation decision strictly on business grounds. The franchisor would be permitted to terminate or cancel a franchise where it was deemed necessary, abusive actions would be limited, and the financial interests of franchisees would be protected.[153]

[152]Franchise Competitive Practice Act of 1967, introduced by Sen. Philip Hart, S. 2321, 90th Cong. (1987).

[153]Barry Kellman, pp. 187-190.

IV. Conclusion

The public debate over the FTC's proposal to preempt state franchise disclosure statutes has perpetuated the misconception that the critical issues of franchising involve conflicting state and federal approaches to franchise regulation. An unfortunate confrontation has been created between federal and state regulators that has prolonged the federal government's preoccupation with franchise disclosure and has diverted attention from more serious problems occurring within franchise relationships.

Despite franchisor complaints of inconsistent and burdensome state regulatory requirements, little evidence has been provided to show that state disclosure requirements have added considerably to franchisor costs, or even that serious discrepancies exist among state requirements in this area. The current regulatory system is unlikely to be made consistent or uniform with actions short of total federal preemption of state laws relating to all aspects of franchise disclosure and regulation. Preemption would have the unwanted consequence of eliminating most of the protections franchisees have gained in state statutes and would significantly reduce current regulatory capabilities by undermining state review and enforcement efforts.

While problems remain to be resolved involving disclosure of franchising earnings claims, the critical issues of franchising no longer center on fraud and misrepresentation in franchise sales. The focus of state regulatory activities, state legislation and legal actions has shifted during the past decade to problems involving abuses within ongoing franchise relationships. Congress has not addressed these "relationship" issues in any comprehensive manner since the late 1960s. Such consideration is long overdue.

Improvement can be made in the current regulatory system with federal actions that are much less intrusive than preemption of state statutes. Actions are required to address the central issues of franchise regulation which arise from the conflicting financial interests of franchisors and franchisees. The complaints of

franchisors regarding the burdensome task of compiling up to eighteen different sets of disclosure documents have had less to do with discrepancies among state disclosure requirements than with the continuing determination of franchisors to resist implementing basic protections for franchisees except where required by state law. In most states franchisees remain without adequate protection against arbitrary or abusive actions by franchisors and without clear legal standing to contest such actions.

Congress must initiate the process of establishing an appropriate balance in franchise regulation between the interests of franchisors and franchisees, and between the interests and capabilities of federal and state regulatory agencies. Essential to such an effort is the development of national standards governing conduct of franchise relations. In much the same manner as federal requirements have established minimum national standards for franchise disclosure, federal legislation is required to provide minimum standards of protection for the legal rights and financial interests of franchisees.

National standards of franchise conduct should be adequate in themselves not only to provide sufficient protection to franchisees, but to encourage uniformity in franchise arrangements nationally. At the same time, states should retain the right to provide additional protections and to continue existing or expanded enforcement efforts. Such standards should incorporate:

- Extension of generally recognized principles of good faith and fair dealing to all aspects of the negotiation, performance and severance of franchise agreements.

- Creation of a federal right of action for franchisees and potential franchisees who sustain loss or injury as a result of violations of federal requirements relating to franchise sales and disclosure and to the conduct of franchise relationships.

- Restriction of the use of procedural devices in franchise agreements that seek to shield franchisors from legal liability or inhibit the exercise of legal rights by franchisees.

- Development of federal standards of good cause relating to terminations, renewals and transfers of franchises. Such standards should include minimum requirements for notice and provide opportunity to correct deficiencies prior to action.

- Establishment of federal guidelines defining the circumstances and financial criteria under which a franchisee may be entitled to remuneration by a franchisor for a portion of the value of a franchise upon termination or cancellation.

Congress recognized the basic legal and financial rights of what was at the time a significant segment of franchising in the Automobile Dealers Franchise Act of 1956 and the Federal Petroleum Marketing Practices Act of 1968. These statutes acknowledged the need for good faith conduct in franchise operations, provided a right of legal action and prohibited franchise terminations without good cause. During the past two decades franchising has grown to such an extent that the franchises covered by these statutes now constitute a small and declining segment of franchising.

The essential issue now confronting federal policy is whether the basic protections and legal principles recognized on a limited basis in federal and state law should be extended broadly to all franchise arrangements. It is not enough for federal policy to simply assure that prospective franchisees are provided with adequate information about franchise opportunities; it must also assure that a fair balance is maintained between franchisors and franchisees throughout the franchise relationship.

Appendix A: Franchise Growth 1969-1986 *(in number of units)*[1]

	Total Franchise	Gain or loss	Product/ Trade Name	% of total	Business Format	Increase #	Increase %
1969	315,045		217,822	69%	97,223		
1970	324,380	9,335	217,028	67%	107,352	10,129	10.4%
1971	356,448	32,068	211,219	59%	145,229	37,877	35.0%
1972	372,909	16,461	216,407	58%	156,502	11,273	7.7%
1973	374,782	1,873	207,838	55%	166,944	10,442	6.7%
1974	362,021	(12,761)	191,363	53%	170,658	3,714	2.2%
1975	353,977	(8,044)	185,443	52%	168,534	(2,124)	(1.2%)
1976	360,034	6,057	183,202	51%	176,832	8,298	4.9%
1977	366,552	6,518	176,309	48%	190,243	13,411	7.5%
1978	368,773	2,221	174,839	47%	193,934	3,691	2.0%
1979	367,207	(1,566)	168,200	46%	199,007	5,073	2.6%
1980	356,896	(10,311)	161,061	45%	195,835	(3,172)	(1.5%)
1981	356,513	(383)	154,513	43%	202,000	6,165	3.1%
1982	355,586	(9,927)	147,988	42%	207,598	5,598	2.8%
1983	355,392	(194)	140,318	39%	215,074	7,476	3.6%
1984	357,335	1,943	136,854	38%	220,481	5,407	2.5%
1985	368,777	11,442	130,998	35.5%	237,779	17,298	7.8%
1986	373,623	4,846	126,959	34%	246,664	8,885	3.7%

Source: U.S. Department of Commerce, *Franchising in the Economy 1986-1988*, February 1988.

[1]Parentheses indicate negative numbers or percentages

Appendix B: Franchise Sales 1969-1986 *[in millions of dollars].*

YEAR	SALES-ALL FRANCHISES	INCREASE FROM PRIOR YEAR	%	PRODUCT/ TRADE NAME	% INC.	BUSINESS FORMAT	% INC.
1969	$ 93,722			82,097		$ 11,625	
1970	95,927	2,205	2.3	82,487	.5	13,440	15.6
1971	114,218	18,291	19.0	98,253	19.0	15,965	18.8
1972	127,077	12,859	11.2	107,650	9.6	19,427	21.7
1973	144,017	16,940	13.3	122,385	13.7	21,632	11.3
1974	146,064	2,047	1.4	121,527	- .7	24,537	13.4
1975	161,084	15,020	10.3	134,204	10.4	26,880	9.5
1976	190,405	29,321	18.2	159,562	19.0	30,843	14.7
1977	230,024	39,619	21.0	190,394	19.2	39,680	29.0
1978	246,844	16,820	7.3	204,092	7.2	42,752	7.7
1979	273,559	26,715	10.8	225,289	10.3	48,270	13.0
1980	285,902	12,343	4.5	231,357	2.7	54,545	13.0
1981	314,168	28,266	9.9	256,110	10.7	58,058	6.4
1982	321,125	6,957	2.2	257,081	.4	64,044	10.3
1983	363,666	42,541	13.2	292,455	13.8	71,211	11.2
1984	428,450	64,784	17.8	350,245	19.8	78,205	9.8
1985	474,670	46,220	10.8	382,044	9.0	92,626	18.4
1986	483,707	9,037	1.9	381,429	- .16	102,278	10.7

Source: U.S. Department of Commerce, *Franchising in the Economy 1986-1988*, February 1988.

Appendix C: Projections of Franchise Growth 1987-1990

I. Franchise Units

	Product Franchise	CD %	Business Format	CD %	Total Franchise	CD %	Reported Franchises[1]
1986	126,959		246,664		373,623		462,123
1987	123,108	-3.0%	266,496	8.0%	389,604	4.3%	479,087
1988	120,071	-2.4%	296,807	11.3%	416,878	7.0%	509,278
1989					438,139	5.1%[2]	535,251
1990					460,922	5.2%	563,084

II. Franchise Sales (in millions of dollars)

	Product Franchises	%	Business Format	%	Total Franchises	%	Total Reported[3]	%
1986	381,429		102,278		483,707		554,800	
1987	396,208	3.9%	112,607	10.0%	508,815	5.2%	599,400	8.0%
1988	414,339	4.5%	128,226	13.9%	542,565	6.6%	639,700	6.7%
1989					574,033	5.8%[4]	676,802	5.8%
1990					607,327	5.8%	716,056	5.8%

[1] Combined number of franchised and franchisor-owned units reported by the Commerce Department and, after 1988, used by the International Franchise Association(IFA).

[2] Percentages based on extending current growth rates projected by the Commerce Department for 1987-1988.

[3] Total sales of both franchised and franchisor-owned units reported by the Commerce Department and, for 1989-1990, the IFA.

[4] Percentages based on IFA's projection of "approximately 6 percent growth in revenues," *U.S.A. Today*, January 4, 1990.

David E. Holmes
Attorney at Law
Franchising
18377 Beach Boulevard, Suite 214
Huntington Beach, California 92648
Telephone # (714) 842-9833
FAX # (714) 848-4966

To: Patricia Peterson

Company: Department of Commerce

FAX No.: 612-296-4328

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ATTORNEY AT LAW
DOMESTIC and INTERNATIONAL FRANCHISING
18377 Beach Boulevard, Suite 214
Huntington Beach, California 92648

FAX (714) 848-4966

(714) 842-9833

November 21, 1990

Patricia L. Peterson
Director of Registration
Department of Commerce
133 East Seventh Street
St. Paul, Minnesota 55101

Re: Arbitration in Franchising

Dear Ms. Peterson:

As an attorney representing both Franchisors and Franchisees for over 15 years and having acted as an arbitrator in Franchisor/Franchisee disputes, I strongly urge your Department to amend its current rules (including particularly Chapter 2860, Section 2860.4400 J.), so as to allow the use of even-handed, binding arbitration clauses in Franchise Agreements.

Arbitration is a favored means of resolving disputes under the Federal Arbitration Act (9 U.S.C. §1 *et seq.*) and recent U. S. Supreme Court and state cases uniformly validate the use of arbitration clauses in Franchise Agreements. As an alternative dispute resolution mechanism, arbitration offers speed, lowered costs and the opportunity to resolve disputes in a less formal and antagonistic forum than a trial court.

In fact, in a recent revision to one of our client's standard Franchise Agreements, discussed with the client's Franchisees beforehand in connection with various renewals, the Franchisees actively requested and approved the introduction of an arbitration clause to the Franchise Agreement, feeling that any possible court trial of a future dispute might expose them to delay and expense that they might not be as well equipped to sustain as the Franchisor. In this instance, the Franchisor was happy to introduce the requested arbitration clause into the standard form agreement and, at last count, all parties remain pleased with it.

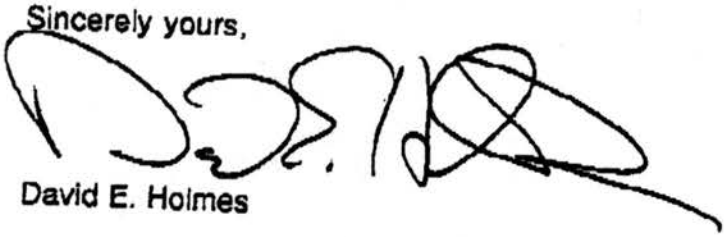
Section 2860.4400 J., as it now stands, is expressly one-sided, allowing the Franchisee to "opt out" of the arbitration clause if it would work to his or her advantage to do so but not giving the Franchisor the same option! This clearly allows the type of maneuvers lawyers delight in indulging in, seeking minor procedural advantages on a case-by-case basis rather than addressing the question of the best overall way to resolve disputes. Given this situation, no rational Franchisor would introduce a clause which may bind him or her but not bind the Franchisee and arbitration will remain largely unimplemented in franchising in Minnesota.

A prudent scheme of regulation might require that the arbitration clause apply to both the Franchisor and the Franchisee and provide for arbitration in Minnesota if the Franchisee is a resident of Minnesota or the franchised business is located in Minnesota. Certainly these protections for the Franchisee are reasonable, fair and do not act to vitiate the wishes of the Franchisor and the Franchisee to provide for the binding arbitration of any future disputes.

Minnesota should allow the Franchisor and the Franchisee, if they wish to do so at the initiation of their legal relationship, to elect to use arbitration as an alternative dispute resolution mechanism, equally binding on both parties. Such a step is not only just, even-handed and consistent with the modern trend to allow parties to use alternative dispute resolution mechanisms (including mediation), but also reduces costs and potential antagonism for all parties. Litigation ends up primarily benefiting the lawyers and if the parties freely decide to use a different mechanism to resolve any differences that might arise in the future, they should be allowed to do so.

Please call us if we can answer any questions or help in any other way. We will attempt to call you on Monday, the 26th, in response to your indication that oral statements may be received through that date, as we consider this matter to be of the utmost importance.

Sincerely yours,



David E. Holmes

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Richard A. Forschler, Esq.
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LAW OFFICES
BRIGGS AND MORGAN
PROFESSIONAL ASSOCIATION

2400 IDS CENTER
MINNEAPOLIS, MINNESOTA 55402

TELEPHONE (612) 339-0661
TELECOPIER (612) 375-1078

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State of Minnesota
Dept. of Commerce
NOV 21 1990
11.58 am

November 20, 1990

Commissioner Thomas H. Borman
Commissioner of Commerce
Minnesota Department of Commerce
133 Seventh Street
St. Paul, Minnesota 55101

Attention: Ms. Patricia Peterson,
Director of Registration

Re: Proposed Changes to Franchise Regulations

Dear Commissioner Borman:

I am writing to register my support for the change in the Minnesota franchise regulations proposed by the Department of Commerce. The proposal would amend the regulations to clarify that parties to a franchise in Minnesota may specify mandatory binding arbitration as the designated method of resolving disputes arising in connection with the franchise.

I believe this change will be helpful to both franchisors and franchisees. The forum in which a dispute is resolved, as between a court room and an arbitration hearing, is less important than that the parties to a franchise have a fair, expeditious and effective means of resolving disputes that they are unable to settle between themselves. Allowing parties to a franchise the flexibility to rely on pre-dispute designation of arbitration should be beneficial to all parties to a franchise.

608522

The Department's notice also requested comment on the impact of this change on small business. Because most franchisors are themselves small businesses, this proposed change in the regulations should have a beneficial impact in that it will facilitate those companies' flexibility in structuring a franchise program that best suits the needs of their particular business sector and the desires of their franchisees. From the franchisees' perspective, arbitration has traditionally been viewed as a favorable means of resolving disputes, suggesting that this change will also benefit those franchisees in Minnesota that are small businesses.

Sincerely,

Andrew C Selden

Andrew C. Selden

ACS:ph

GRAY, PLANT, MOOTY, MOOTY & BENNETT, P.A.

LAW OFFICES

HAROLD G. CANT (1887-1973)
HENRY W. HAVERSTOCK (1894-1977)
FRANKLIN D. GRAY (1904-1990)

3400 CITY CENTER
THIRTY THREE SOUTH SIXTH STREET
MINNEAPOLIS, MINNESOTA 55402
TELEPHONE 612 • 343-2800
FAX 612 • 333-0066
TWX 910-576-2778

FRANK W. PLANT, JR.
JOHN W. MOOTY
MELVIN R. MOOTY
SHEFFIELD WEST
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DIRECT DIAL 343-2956

November 20, 1990

Thomas H. Borman
Commissioner of Commerce
Minnesota Department of Commerce
133 East 7th Street
St. Paul, MN 55101

State of Minnesota
Dept. of Commerce
NOV 21 1990
Rec'd 11:58 am

Attention: Ms. Patricia Peterson,
Director of Registration

Re: Proposed Change to Franchise Regulations

Dear Commissioner Borman:

On behalf of the Business Law Section of the Minnesota State Bar Association, we are writing to support the Department's proposal to amend Minnesota's franchise regulations (Minn. R. § 2860.0100, et seq.) to restore the ability of parties to a franchise to specify mandatory binding arbitration as a preferred means of dispute resolution.

We believe this change is appropriate, both to conform to the terms of the Federal Arbitration Act (9 U.S.C. § 1, et seq.) and to enhance the ability of parties to a franchise to pursue non-judicial resolution of disputes. We believe this contractual flexibility will best serve the needs of Minnesota's small businesses, franchisee and franchisor alike.

We would be pleased to provide additional information or comments if you believe it would be helpful, or to testify should you convene a hearing.

Cordially,

Beth Brody

Mary Beth Brody,
Chair, Franchising Subcommittee-
Business Law Section, MSBA

MBB:smm
1421X

FAX TRANSMITTAL FORM

INTERNATIONAL FRANCHISE ASSOCIATION
1350 New York Avenue, NW, Suite 900
Washington, DC 20005-4709

Telephone: 202/628-8000
FAX: 202/628-0812
Telex: 323175

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Robert E. Pirtle
General Business Services, Inc.

Maury C. Roe
The Coca-Cola Company

Jerome F. Sheldon
Medicine Shoppe International, Inc.

John D. Snodgrass
Days Inns of America, Inc.

Loren D. Steele
Super 8 Motels, Inc.

Carl C. Zwisler
Cooter & Gell

William B. Cherkasky
President and Chief Operating Officer

November 26, 1990

Patricia L. Peterson
Director of Registration
Department of Commerce
133 East Seventh Street
St. Paul, MN 55101

Dear Ms. Peterson:

In accordance with the Notice To Solicit Outside Opinion Regarding Proposed Amendment To Franchise Rules, Including The Impact Of The Rules On Small Business published in the Minnesota State Register on Tuesday, November 13, 1990, the International Franchise Association (the "IFA") submits this letter of comment.

The IFA is an organization comprised of over 650 franchising companies which engage in franchising activities throughout the United States. Members of the IFA vary from large, well established franchising companies to start-up franchising companies with little franchise experience. The IFA members are very interested in the proposed regulation of arbitration agreements. The speed and cost/benefit of arbitrating claims has resulted in widespread growth and acceptability of the arbitration process within the franchise community. Increasingly, franchisors elect to include arbitration provisions in their franchise and area development agreements. The American Arbitration Association reported that in 1989, the Association handled 401 franchise arbitration cases in which the total of all claims presented was in excess of $22.5 million. This represents a 500% increase over the number of franchise arbitration cases handled in 1981. (See, Bus. Fran. Guide (CCH) Supplementary Insert No. 124, p. 2).

The growth of arbitration as an alternative to litigation has occurred within the franchise community in spite of efforts by state legislators and regulators to restrict or prohibit the use of arbitration provisions in franchise agreements. State-imposed restrictions or prohibitions on validly structured arbitration agreements potentially contravene the

Federal Arbitration Act ("FAA")[1] and, therefore, the Supremacy Clause of the United States Constitution, which empowers Congress to pre-empt state law. Recent judicial decisions have struck down the effect of certain of these restrictions and indicate that other current practices and requirements of state franchise regulators may also be struck down. Accordingly, the IFA opposes any attempt by state franchise regulators to restrict or inhibit the use of validly structured arbitration agreements. The IFA recommends that the Department of Commerce Rule (Chapter 2860, §2860.4400 J.)(analyzed below) be modified to delete the requirement that an exclusive arbitration clause permit the franchisee to opt out of the requirements of the arbitration clause.

The scope of the preemptive effect of Section 2 with respect to conflicting state franchise laws first arose in Southland Corp. v. Keating, 465 U.S. 1, 104 S. Ct. 852 (1984). Southland's standard form franchise agreement contained a provision requiring that "any controversy or claim arising out of or relating to [the franchise agreement] or the breach thereof shall be settled by arbitration in accordance with the Rules of the American Arbitration Association ... " After various franchisees filed separate actions against Southland in the California courts, alleging, among other things, fraud, oral misrepresentation, breach of contract, breach of fiduciary duty and violations of the disclosure requirements of the California Franchise Investment Law, Southland petitioned the courts in all cases to compel arbitration of all claims. After conflicting lower court decisions, the California Supreme Court ruled that claims asserted under the California Franchise Investment Law were not arbitrable on the basis of Section 31512 of the California Corporations Code, which provided that "any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void." The California Supreme Court interpreted that section to provide franchisees with a right to seek judicial resolution of claims brought under the California franchise laws and accordingly, refused to enforce contracts to arbitrate such claims.

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1 The Federal Arbitration Act provides:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.
>
> 9 U.S.C. § 2.

In this case, the United States Supreme Court held that a provision of the California Franchise Investment Law which purported to void mandatory arbitration agreements directly conflicted with Section 2 of the FAA and violated the Supremacy Clause. In its analysis, the Supreme Court stated that "in enacting Section 2 of the [FAA], Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which contracting parties agreed to resolve by arbitration." Southland Corp., 104 S.Ct. at 858.

Subsequent Supreme Court and lower Federal Court decisions have reasserted the strong federal policy in favor of arbitration and reaffirmed the supremacy of the FAA over state statutes seeking to preclude arbitration of certain state statutory claims. See e.g., Perry v. Thomas 482 U.S. 483, 107 S.Ct. 2520, 2525 (1987); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 107 S.Ct. 2332, 2337 (1987); Securities Industry Association v. Connolly, 703 F. Supp. 146 (D. Mass. 1988), aff'd, 883 F.2d 1114 (1st Cir. 1989).

A recent decision rendered by the United States District Court for the District of Minnesota held that a rule promulgated by the Minnesota Department of Commerce (the "Old Rule"), as applied by the Department to prohibit the inclusion of a mandatory arbitration clause within a franchise agreement, was inconsistent with, and therefore in violation of, the FAA. Seymour v. Gloria Jean's Coffee Bean Franchising Corp., 732 F.Supp. 988 (D. Minn. 1990).

In December 1989, the Commissioner published proposed revisions to its arbitration rule (the "New Rule"). The New Rule became effective on May 21, 1990 and provides:

> . . .It shall be unfair and inequitable for any person to. . .require a franchisee to waive his rights to a jury trial or to waive his rights to any procedure, forum, or remedies provided for by the laws of the jurisdiction, or to consent to liquidated damages, termination penalties, or judgment notes; provided, that the franchise agreement may contain an exclusive arbitration clause if the agreement allows the franchisee to opt out of the requirements of the clause.

The New Rule permits franchisees to "opt out" of an arbitration agreement yet does not indicate when such an "option" must be exercised. Though the Department may have intended the New Rule to permit a franchisee to opt out of arbitration only by not signing the rider at the time of executing the franchise agreement, a possible interpretation of the New Rule is that a franchisee may "opt" to litigate a dispute notwithstanding the presence of a binding arbitration provision within the franchise agreement, years after the parties execute the agreement. Even if it only permits opt out at the time of entry into a franchise relationship, the New Rule constitutes a constitutionally

impermissible interference with the rights of private parties to include binding arbitration as an agreed term of their contract under the FAA.

As the Seymour decision illustrates, practices of state regulators interpreting their statutes to authorize the regulator to require modification of arbitration provisions in franchise agreements likewise contravene the FAA and are therefore preempted. Such practices include the requirements imposed by state regulators to require arbitration proceedings to be conducted either in their respective state or "at a mutually agreeable site". The constitutional infirmity of these intrusions into the formation of arbitration agreements is clear from a decision of the Eighth Circuit Court of Appeals in Webb v. R. Rowland & Co., Inc. 800 F.2d 803 (8th Cir. 1986). In Webb, the court held the failure of a contracting party to place a 10-point boldface type notice that the contract contained a binding arbitration provision did not render the otherwise valid arbitration agreement unenforceable, notwithstanding the fact that the failure to include the notice was a violation of state law. It is clear that the insertion of a boldface type notice regarding an arbitration provision is much less intrusive than a requirement by a state regulator to modify the arbitration provision to require arbitration at a designated location different from the site initially specified in the agreement. In Scanlon, et. al. v. P & J Enterprises, Inc., et. al., Bus. Fran. Guide (CCH) ¶9586 (Mich. Ct. App. 1990), the court stated unequivocally that a statutory provision requiring arbitration to be conducted within the State of Michigan was preempted by the FAA.

The judicial history of the FAA is replete with decisions upholding the right to arbitrate despite the initiatives of state regulatory agencies which have attempted to "protect" parties from enforcement of arbitration agreements. As the United States Supreme Court noted in Southland Corp. v. Keating, 465 U.S. 1, 104 S.Ct. 852, 79 L.Ed. 2d 1 (1984), "Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements" by enacting the FAA. Given this pronouncement, it is clear that regulatory attempts to restrict the terms of arbitration agreements must also fail.

There has been a long and on-going debate among businessmen and attorneys over the relative advantages and disadvantages of litigation and arbitration. It is important to note that a principal advantage of arbitration is substantially lower cost, a result that is presumably at least as important to a franchisee as to a franchisor. Contrary to the widely held belief that franchisees are usually plaintiffs represented by contingent fee lawyers (and, therefore, indifferent to the cost of litigation), franchisees are very often defendants required to pay $100.00 to $250.00 per hour for legal representation. Arbitration may be disadvantageous to a franchisee in some instances and confer significant advantages in others. Franchisors adopt arbitration for the reason that on balance, over the long term, it will be the most effective and efficient dispute resolution method, not that it will be such in every dispute. It is not possible to predict whether arbitration will generally afford the franchisor a tactical advantage. The

factors that will determine whether a franchisor is in a better position in court or before an arbitrator in a given dispute are numerous and not predictable and an informed decision to utilize arbitration to resolve disputes is based on the economies and efficiencies that arbitration is thought to assure in the long run.

Accordingly, the IFA respectfully requests the rescission of the "opt out" requirement currently set forth in the New Rule.

Very truly yours,

INTERNATIONAL FRANCHISE ASSOCIATION

Frank E. Darling

DEPARTMENT OF COMMERCE *STATE OF MINNESOTA*

Office Memorandum

To: *Pat Peterson*

From: *Thomas H. Borman*
Commissioner

Date: *December 6, 1990*

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Regarding letter from ***Don Drysdale***

Please review the attached correspondence and respond by ***December 21, 1990****.*
Please also return this memo along with a copy of your response to Pam.

Thank you.

T.H.B.

Note:
THB:pjk
Encl.

SOLISH, JORDAN & WIENER
A PROFESSIONAL CORPORATION
Attorneys at Law

DON M. DRYSDALE
STANLEY M. GORDON

SUITE 700
610 NEWPORT CENTER DRIVE
NEWPORT BEACH, CALIFORNIA 92660
Telephone (714) 760-9677 *Facsimile* (714) 760-9551

LOS ANGELES OFFICE
FIFTEENTH FLOOR
12100 WILSHIRE BOULEVARD
LOS ANGELES, CALIFORNIA 90025
Telephone (213) 826-2255
Facsimile (213) 207-3230

JAMES V. JORDAN
JONATHAN SOLISH
STEVEN D. WIENER
DOUGLAS P. BEDARD
LYN SKINNER FOSTER
NANCY J. SMITH
LUCIEN A. SCHMIT, III
JUDITH B. GITTERMAN
SONIA DEL VALLE
ANDREW M. MORROW, III
NANCY DOYLE
REBECCA J. JOHNSON
LAURIE S. ARMSTRONG
PAUL A. MAAS
SANDRA C. WESTON
ILENE M. GOLDBERG

Of Counsel
LEONARD LOW

STATE OF MINNESOTA
DEC 03 1990
DEPARTMENT OF COMMERCE

November 28, 1990

Commissioner Thomas H. Borman
Commissioner of Commerce
Minnesota Department of Commerce
133 Seventh Street
St. Paul, MN 55101

RE: Proposed changes to franchise regulations

Dear Commissioner Borman:

It is my understanding that regulations have been proposed by the Department of Commerce which would allow parties to franchise agreements in Minnesota to specify mandatory binding arbitration as the designated method of resolving disputes arising in connection with the franchise. In addition to being a partner at Solish, Jordan & Wiener, I am president and co-founder of Franchise Arbitration and Mediation, Inc., a private service specializing in alternative forms of resolution (including arbitration) of franchising disputes.

Obviously, we support the ability of parties to designate binding arbitration as a method of resolving disputes in their franchise agreements. We believe that the informal and less expensive nature of arbitration is a benefit to both franchisors and franchisees in connection with resolution of most disputes which may arise between them. For this reason, we support the proposed amendment to the regulations.

However, we do not support (and, frankly, question the constitutionality) any state mandate of a specific non-governmental organization (such as the American Arbitration Association) as the sole arbitration organization acceptable in Minnesota in a binding arbitration context.

With respect to the question of impact on small business of the proposed change in regulation, when comparing the excessive cost and overburdening complexities of most litigation proceedings to the relatively straightforward and less expensive process of arbitration, the impact on small business is self-evident. We represent franchisors of all sizes, as well as franchisees, and most have commented favorably on the arbitration process. It is clear that arbitration is not appropriate for the resolution of every dispute which may arise, and certain matters should be relegated to the court process. However, it has been my experience

that the typical franchise dispute is one that is more easily resolved through the arbitration process and I believe most of my clients would concur with this opinion.

Should you have any questions concerning this letter, please feel free to call.

Very truly yours,

Don M. Drysdale

DON M. DRYSDALE

DMD:gd

In the Matter of the Proposed Adoption of the Rule Relating to Franchises

AFFIDAVIT

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

Patricia L. Peterson, being sworn says:

No one has requested notification of the date of submission of the Rule to the Attorney General and therefore, the Affidavit of Mailing Notice of Submission of the Rule to Attorney General pursuant to Minn. Rule 2010.0300 is inapplicable.

PATRICIA L. PETERSON
Director of Registration

Subscribed and sworn to before me this 12th day of February. 1991.

NOTARY PUBLIC

CYNTHIA L. CLAASON
NOTARY PUBLIC-MINNESOTA
RAMSEY COUNTY
MY COMMISSION EXPIRES FEBRUARY 11, 1992

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed
Adoption of the Permanent Rules
of the Department of Commerce
Relating to Franchise Arbitration

DECLARATION
OF COUNSEL

I, Louis Hoffman, Special Assistant Attorney General, do hereby declare that I have examined the above-captioned rules, and the supporting rulemaking record, and that, based on my examination, the Administrative Procedures Act and Minnesota Rules, chapter 2010, have been followed. Any exceptions are listed below. For Attorney General billing purposes, the four-digit docket client code is 0126.

LOUIS HOFFMAN
Special Assistant
Attorney General

Dated: February 13, 1991

H.rbl