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Beguiling Heresy: Regulating the Franchise Relationship

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** Gerald Leonard Lescatre (1958-2003) passed away before this article was completed. A 1984 graduate of the New York Institute of Finance (A.S. Finance), Gerry was a Registered Securities Principal and Registered Options Principal. He specialized in the food service industry and participated in the Initial Public Offerings of franchisors Manhattan Bagel and New World Coffee. At the time of his passing, Gerry was a kind and generous operator of a Subway™ in New York City for seven years. Gerry's concern for his employees is fondly remembered, as is his belief that fair franchising provides opportunities for all. He would acknowledge his parents Robert and Clarisse Lescatre of Manchester, N.H.

I. Introduction

As franchising[1] grows both in the United States and abroad, cases of franchisor[2] opportunism continue to increase. The franchise industry and many regulators insist that there is no evidence of systemic problems with franchising, and that any historical problems were addressed by the disclosure regime implemented with the passage of federal disclosure

1. The legal definition of "franchise" depends on local law. *See* FRANCHISE DESK BOOK: SELECTED STATE LAWS, COMMENTARY & ANNOTATIONS (W. Michael Garner ed., 2001). Frequently, the distinction between a franchise and a distributorship is the payment of a franchise fee. *See, e.g.*, Cambee's Furniture, Inc. v. Doughboy Recreational, Inc., 825 F.2d 167, 169 (8th Cir. 1987). However, this is not dispositive, especially where payments are required as a condition of continuing the business. FTC Informal Staff Advisory Opinion 00-2, Jan. 24, 2000 *at* Bus. Franchise Guide (hereinafter BFG) (CCH) ¶ 6506. In some cases, the courts use "franchise" and "distributorship" interchangeably; although, where a distributor does not qualify as a statutory franchisee, the arrangement may not fall within the reach of franchise statutes. *E.g.*, Upper Midwest Sales Co. v. Ecolab, 577 N.W.2d 236 (Minn. Ct. App. 1998). In some Commonwealth cases, courts use the term "independent contractor" for what would be regarded in the U.S. as a distributorship or franchise. In the U.S., the term "business opportunity" may be used to describe a distributorship arrangement, and is often a pejorative term when used by regulators. The regulatory creation of a "Fractional Franchise," which is defined in section 436.2(h) of the FTC Rule makes matters more confusing. *See* BFG ¶¶ 6080, 6173.

2. The franchisor is the company which licenses the trademark, and the franchisee is the licensee. Some franchisees are also franchisors, such as AmeriHost Hotels. Julie Bennett, *Hotels and Franchising—Is Adding a Hotel to Your Portfolio a Good Idea?*, FRANCHISE TIMES, Feb. 2000 at 24, 25. The largest Burger King franchisee, Carrols Corp., is also a franchisor of Taco Cabana and Pollo Tropical. *Carrols Halves 2nd-Q Net on 10.5% BK Comp-unit Slide*, NATION'S RESTAURANT NEWS, Sept. 1, 2003, at 11.

requirements thirty years ago. This paper sets forth a wide range of abusive practices found in hundreds of legal cases from around the globe and across franchise systems. The majority of cases cited are recent cases. Virtually all of the cases cited deal with abuse occurring after signing of the franchise contract; abuse not covered by federal disclosure rules. Franchisors use arbitration clauses and forum selection clauses to minimize franchisee claims of abuse and ensure that any claims made are kept out of publicly available records. In the face of these abuses, there is regulatory inaction and constraints on the ability of courts to rectify the abuses permitted under contracts of adhesion.[3] Regulatory capture and the limitations of judicial intervention *ex post* are significant impediments to reining in franchisor abuse which must be addressed in the United States, as they have been in some foreign countries, by franchise relationship legislation.

Any analysis of franchise regulation must take into account franchise realities, both with respect to the contract itself and the sophistication of the parties entering into the contract. As one court observed:

> Although franchise agreements are commercial contracts they exhibit many of the attributes of consumer contracts. The relationship between franchisor and franchisee is characterized by a prevailing, although not universal, inequality of economic resources between the contracting parties. Franchisees typically, but not always, are small businessmen or businesswomen . . . seeking to make the transition from being wage earners and for whom the franchise is their very first business. Franchisors typically, but not always, are large corporations. The agreements themselves tend to reflect this gross bargaining disparity. Usually they are form contracts the franchisor prepared and offered to franchisees on a take it or leave it basis. Among other typical terms, these agreements often allow the franchisor to terminate the agreement or refuse to renew for virtually any reason, including the desire to give a franchisor-owned outlet the prime territory the franchisee presently occupies.[4]

A car wash franchisor told the Federal Trade Commission (FTC):

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3. An adhesion contract is a contract drafted by a stronger party (*e.g.*, franchisor) and presented to the weaker party, without giving the later party the opportunity to negotiate terms. As noted in this paper, civil law countries take a different view of freedom of contract; the adhesory concept was introduced to the U.S. by a lawyer who had fled Europe. Friedrich Kessler, *Contracts of Adhesion: Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).

4. Postal Instant Press, Inc. v. Sue Sealy, 51 Cal. Rptr. 2d. 365, 373 (Cal. Ct. App. 1996) (internal citations omitted). *But see*, E. ALLAN FARNSWORTH, CONTRACTS § 4.28 (1999) ("Many courts . . . have not shared this attitude toward franchisees.").

> [F]ranchisee[s] don't even know how they are getting screwed and half of them are so stupid. The people that call me to buy a franchise are so dumb, they don't even know what to ask or how to do it. And I could screw every one of them if I wanted to. But I don't, and I don't [sic]. And it looks like other franchisors do and they are getting really good at it.[5]

Franchisors speak of a partnership between franchisor and franchisee,[6] but the legal approach taken by franchisors has been positivist, adversarial, and centered on a commercial model targeted at unsophisticated consumers. Conceptually coherent but counterproductive in practice, (both for franchisor and franchisee) this approach is at variance with the trend in consumer law both domestically and abroad. Some franchisees are large corporate entities, but many franchises are purchased by individuals with a limited business background. Franchisors speak of the sophistication of two parties to a commercial business contract, but the evidence belies this, as does the franchisors own marketing strategy.[7]

The International Franchise Association (IFA) has said that a business format franchise involves three elements: "(1) the licensing of a protected trademark, (2) no negotiability on the part of the franchisee, and (3) ongoing interaction between the franchisor and the franchisee."[8] To the extent that the franchise relationship is one between a sophisticated commercial entity and an unsophisticated franchisee signing a contract of adhesion, regulation of the relationship must take into account the potential for post-contractual overreaching and abuse of the weaker party.

A majority of countries that regulate franchising have a disclosure regime alone, and do not regulate the franchise relationship.[9] This

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5. Lance Winslow, Car Wash Guys International, phone message to ANPR Hotline (Comment 84), May 22, 1997, 10:10 pm, *available at* http://www.ftc.gov/bcp/franchise/comments/84winslo.htm. Winslow, whose business address was a mail drop, was subsequently the target of an FTC complaint. http://www3.ftc.gov/os/2000/08/carwashcmpt.htm (posted 8/09/00).

6. INTERNATIONAL FRANCHISE ASSOCIATION, IFA'S FRANCHISE OPPORTUNITIES GUIDE 34 (Fall/Winter 2000). *"Go Into Business For Yourself, Not By Yourself!"* proclaims the glossy cover. Robert T. Justis & William Slater Vincent, ACHIEVING WEALTH THROUGH FRANCHISING (2001). The back cover reads: "THE OPPORTUNITY TO BE IN BUSINESS FOR ONESELF BUT NOT BY ONESELF!" in red capital letters 1" tall. *See id.*

7. *E.g., Be Your Own Boss: A Franchise Formula Unlike Any Other, available at* www22.inetba.com/harrisresearchinc/franchise.ivnu ("You can own a Chem-Dry business for as little as a monthly car payment.").

8. Tele-Communications, Inc. v. C.I.R., 95 T.C. 495, 511 (1990) (testimony of William B. Cherkasky, President, Int'l. Franchise Assn.).

9. Philip F. Zeidman, *Another Precinct Reports In . . .*, FRANCHISE TIMES, Sept. 2000 at 45 (noting "Venezuelan Resolution" as one of "relatively few . . . efforts at the

especially impacts unsophisticated purchasers who do not realize that the impressive-looking offering circular is the extent of franchise regulation. The authors have heard from franchisors that to require a different standard for less-sophisticated franchisees would be unworkable and that pre-sale disclosure provides an adequate remedy. Yet franchisors argue in favor of creating new federal "Sophisticated Investor Exemptions" and against disclosure to prospective franchisees of lawsuits brought by franchisors against current franchisees.[10]

To acknowledge the presence of sophisticated purchasers is to acknowledge the presence of unsophisticated purchasers, and as this paper shall show, some franchisors target those unsophisticated purchasers. In such cases, the implied covenant of good faith and fair dealing should be applied as in a consumer contract, and may override express provisions of the contract in certain instances—particularly where the franchisor uses an integration clause to exclude evidence of willful misrepresentation by agents of the franchisor.[11]

The State of Illinois observed that franchisors may induce purchasers to rely on a representation, "but only after meeting with a lawyer does the franchisee realize that the representation was meaningless because of the integration clause and contract law . . . a franchisor should be held to the written representations in its UFOC [Uniform Franchise Offering Circular]."[12] The North American Securities Administrators Association told the FTC that integration clauses "have served as mechanisms for franchisors to avoid liability for disclosure violations," and the majority of franchise agreements contain such a clause.[13] Proposals by the FTC to limit abuse of integration

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regulation of the franchise relationship"); Philip F. Zeidman, *Malaysia: Still a Mixed Bag*, FRANCHISE TIMES, Oct. 2000 at 56 (stating that Malaysian relationship law "[interferes] in the parties' own capacity to strike a bargain").

10. Letter from Kenneth S. Kaplan, Asst. Gen. Counsel, AFC Enterprises, to Sec'y FTC (Dec. 20, 1999), *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/comment030.htm (AFC is a parent of Popeye's Chicken, Church's Chicken, and Cinnabon). *See also* Letter from Eugene Stachowiak, VP Franchising, McDonald's Corp., to Sec'y FTC (Dec. 20, 1999), *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/mcdonalds.pdf (supporting Sophisticated Investor Exemption). Triarc (Arby's, Pasta Connection, T.J. Cinnamons), Wendy's, and Marriott were some of the other franchisors supporting the Sophisticated Investor Exemptions. *Id.*

11. *Contra,* Olympus Hills Shopping Ctr., Ltd. v. Smith's Food & Drug Ctrs., Inc., 889 P.2d 445, 450 n.4 (Utah Ct. App. 1994) ("[T]he obligation of good faith is 'constructive' rather than 'implied' because the obligation is imposed by law and cannot be disclaimed.").

12. Letter from Robert Tingler, Franchise Bureau Chief, to Donald S. Clark, Sec'y FTC (Jan. 31, 2000), *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/comment038.htm.

13. Letter from Dale E. Cantone, Stephen W. Maxey & Joseph J. Punturo, to Donald

clauses by requiring the clause to exclude statements in the UFOC or its exhibits have been met with resistance from the franchise industry.[14] The fact that franchisors refuse to be bound by their written offering circulars, let alone the verbal representations of franchisor salespeople, is indicative of franchisor attitudes toward franchisees, courts, and regulators. It is true that non-parties to the agreement, such as regulators, are not parties to the contract, and hence not bound by the integration clause. But as the story of franchise regulation unfolds in this paper, it shall become apparent that regulators have not always been zealous guardians of franchisee victims, and the courts tend to regard the integration clause as sacrosanct.

The ability of American franchisors to use the Federal Arbitration Act[15] and choice of forum/choice of law provisions would severely constrain even the most ambitious state Attorney General. Franchisors who do not wish to follow a specific state law have the ability to choose the law of a friendlier forum, and can avoid American law altogether by specifying an overseas forum.[16] A growing body of case law recognizes that the significant expense of arbitration may be used to prevent the

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S. Clark, Sec'y FTC (Dec. 29, 1999), *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/comment017.htm.

14. Letter from Steven Goldman & Mark Forseth, Marriott International Inc., to Sec'y FTC (Dec. 22, 1999), *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/comment035.htm. The Marriott hotel franchisor called the FTC proposal "a bit draconian." *Id.* One franchisor admits the problem: Tricon recognized that integration clauses could be abused, and suggested stating that it is a deceptive practice "to use integration clauses in a manner intended to deceive." *Id. See also* Letter from Brian H. Cole, TRICON Global Restaurants, Inc., to Sec'y FTC (Jan. 11, 2000), *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/comment034.htm.

15. 9 U.S.C. §§ 1-307 (2004).

16. Mitsubishi Motors Corporation v. Soler Chrysler-Plymouth Inc., 473 U.S. 614 (1985) (preempting Puerto Rican law and ordering arbitration in Japan); Southland Corp. v. Keating, 465 U.S. 1 (1984) (preempting California Franchise Investment Law); Doctor's Associates Inc. v. Casarotto, 517 U.S. 681 (1996) (preempting Montana law); Doctor's Associates Inc. v. Hamilton, 150 F.3d 157 (2d Cir. 1998) (preempting New Jersey Franchise Protection Act and ordering arbitration in Connecticut); Alphagraphics Franchising Inc. v. Whaler Graphics Inc., 840 F. Supp. 708 (D. Ariz. 1993) (preempting Michigan Franchise Investment Law and ordering arbitration); KKW Enterprises Inc. v. Gloria Jean's Gourmet Coffees Franchising Corp, 184 F.3d 42 (1st Cir. 1999) (preempting Rhode Island Franchise Investment Act and ordering arbitration in Illinois); M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1970); Vimar Seguros y Reaseguros S.A. v. M/V Sky Reefer, 515 U.S. 528 (1995) (holding that U.S. citizen must arbitrate in Japan). *See also*, Margaret M. Harding, *The Clash Between Federal and State Arbitration Law and the Appropriateness of Arbitration as a Dispute Resolution Process*, 77 NEB. L. REV. 397 (1998). On history of choice of law in West, see William J. Woodward, Jr., *Symposium on Revised Article 1 & Proposed Revised Article 2 of the Uniform Commercial Code: Contractual Choice of Law: Legislative Choice in an Era of Party Autonomy*, 54 SMU L. REV. 697, 711-15 (2001).

exercise of legal rights.[17] Where expense renders franchisee remedies illusory, local regulation of the franchise relationship can prevent franchisors from retaining the fruits of opportunism.[18] Arbitration presents ethical challenges not faced in the judicial process.[19]

One of the difficulties in ascertaining the presence of (or lack of) franchisor abuse is the lack of franchisee claims in judicial forums. American Franchisee Association president, Susan Kezios, notes that due to arbitration clauses, "decisions on resolving [abuse] issues are occurring behind closed doors in private, and so we don't really know what is going on."[20] Reported franchise cases are the tip of the proverbial iceberg, and only franchisors know the extent and nature of discord in franchising. Franchisees themselves are reluctant to go public for fear of loss of their franchise, the prospect of a franchisor hiring private detectives to follow and photograph franchisees and their families as they go about their personal lives, and the ability of the franchisor to audit personal tax returns in order to prod the government into initiating criminal charges against franchisees.

New York State Attorney General Eliot Spitzer chides prospective franchisees, saying "All too often, franchisees submit complaints to my office regarding matters that would not have occurred if the investor had thoroughly researched the franchise industry and the particular system of which they became a part."[21] Spitzer claims that his goal is "transparency."[22] However, under current law, little information is provided to the franchisee; franchisors are not required to give complete disclosure of litigation/arbitration against franchisees and gross/net income data. If state regulators are serious about transparency, and if the franchise industry is serious about providing prospects with maximum information, there should be support for a change to the FTC's Franchise

17. *But see*, Stephen J. Wolfe, *Arbitration Under Assault: Trial Lawyers Lead the Charge*, CATO INSTITUTE, *available at* www.cato.org/pubs/pas/pa433.pdf (stating that arbitration is cheaper than court, providing greater access to justice and respects contractual freedom).

18. Mark P. Gergen, *The Use of Open Terms in Contract*, 92 COLUM. L. REV. 997, 1002 (1992) ("Contractual opportunism generally involves a party's attempt to capture a greater share of the return on a contract. Sometimes this self-aggrandizement is condemned because it reduces the joint return on a contract; other times, it is condemned because it violates contract-based expectations.").

19. For example, "neutrals" are compromised by economic entanglements with one of the parties, or arbitral bodies which are compromised by dependence on the (corporate) drafter of the franchise agreement who selects the arbitral body which will be used (and paid) in the event of a dispute.

20. Milford Prewitt, *Encroachment 'Battlefield' Now More Peaceful*, NATION'S RESTAURANT NEWS, Feb. 24, 2003 at 1, 43-44.

21. Elliot Spitzer, *What to Consider Before Buying a Franchise, available at* http://www.oag.state.ny.us/franchise/before_buying_franchise_brochure.html.

22. David J. Kaufmann, *Spitzer Rules*, N.Y.L.J., Dec. 19, 2002 at 3.

Rule to require disclosure of such information,[23] and for the dissemination of an Offering Circular prior to any sales pitch by the franchisor, including at trade shows.

From a legal perspective, the franchise relationship is above all a contractual relationship.[24] Since the nature of the relationship is contractual, implied terms and conditions may exist in franchise agreements just as they do in any other agreement. Implied terms may be mere "gap-fillers," but they may also be a reflection of the primacy of norms other than freedom of contract. This paper will discuss recent developments in economics and cognitive neuroscience, which highlight the inadequacy of approaches to economic and political theory epitomized in current franchise jurisprudence.[25] In less than a decade, behavioral economics has progressed from birth to a respectful hearing before the Federal Reserve Board of Governors and articles in popular media;[26] its influence on the franchise industry has yet to be felt.

Of the implied contractual terms, perhaps the most controversial is that of good faith and fair dealing. Good faith is a far less controversial issue in civil law systems than in common law systems, and more controversial in Great Britain than in the United States; the historical reasons for this distinction shed some light on the current debate over the use of the implied covenant in franchise agreements. Freedom of Contract and Implied Terms in Contract are separate but related concepts; Freedom of Contract in its purest form is incompatible with certain implied terms, such as good faith,[27] and this observation has led

23. Proposed changes to the Franchise Rule were announced in 1999. *See* Franchise Rule, 64 Fed. Reg. 57294 (proposed Oct. 22, 1999).

24. This does not mean that the terms of the contract are negotiated, as the IFA itself admits. *See* Brief for the International Franchise Assn. and the Securities Industry Assn., as *amici curiae,* at 20, Doctor's Associates Inc. v. Casarotto, 517 U.S. 681 (1996) (No. 95-559), *available at* 1996 WL 78299 (for Westlaw) and 1995 U.S. Briefs 559 (for Lexis) (Franchisors would face the "burdensome task of tailoring their contract documents to meet the varying and often conflicting arbitration laws of 50 different states.") Since the franchise industry balks at drafting different documents for each state, it is unlikely to ever support true negotiation of franchise agreements.

25. The result of neurobiology has been a blurring of traditional distinctions between "conservative" and "liberal" positions on government regulation. Steven Pinker of MIT, a political conservative, notes, "Conservatives have always invoked limitations on human reason to rein in the pretense that we can understand social behavior to redesign society. But those limitations also undermine the assumption of rational self-interest that underlies classical economics and secular conservatism." STEVEN PINKER, THE BLANK SLATE: THE MODERN DENIAL OF HUMAN NATURE 302 (Viking Penguin) (2002). Moreover, to the extent that market failure occurs in the franchise industry, resultant externalities may justify regulation purely on a cost-benefit basis.

26. Stephen J. Dubner, *Calculating the Irrational in Economics*, N.Y. TIMES, June 28, 2003, at B7.

27. Of course, this depends on ascertaining what good faith is; Judge Posner observed, "[I]t is a chameleon." Empire Gas Corp. v. American Bakeries Co., 840 F.2d

to a retreat from the modern view of good faith enunciated in the Uniform Commercial Code and the Restatement (Second) of Contracts, substituting the textualist "gap-filler" analysis found a century ago.

Texaco, Inc. v. A.A. Gold, Inc.[28] dismissed arguments that franchise agreements are contracts of adhesion warranting exercise of equitable remedies, and cited a hundred-year old English case, which said "that men of full age and competent understanding shall have the utmost liberty of contracting."[29] Both society and the laws that regulate it have changed in the last hundred years. In modern society, individual purchasers of franchises are often unsophisticated consumers accustomed to the substantial body of law which *does* restrict freedom of contract in everything from conditions of employment to automobile purchases. The public policy underlying such law (including franchise relationship statutes) is that there are societal concepts of fair play to be upheld, as well as a desire to minimize negative externalities created by oppressive contractual terms in contracts of adhesion.

This paper holds that the current American view of the implied covenant of good faith and fair dealing is too narrow, and franchisors operating globally will have to comply with the substantial body of international civil law that is both more receptive to good faith and broader in the applications of the doctrine. Foreign regulation of franchising is in its infancy, but it is worth noting that Korea has taken an activist stance with respect not only to American-style disclosure, but also to the franchise relationship. The general counsel to the American franchise industry group (International Franchise Assn.) noted Korea's "repetitive use of a standard of 'fairness,'" and commented that the Korean franchise dispute resolution mechanism "is like nothing we have ever seen in the world of franchising. Much the same can be said of [Korean franchise] legislation in its entirety."[30] As noted below, concerns about relationship issues are also seen in jurisdictions ranging from Canada to Australia.

Reliance on judicial or arbitral application of equitable principles is insufficient, and statutory mandates are required to make franchisors responsible for the consequences of opportunistic behavior. Such

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1333, 1339 (7th Cir. 1988). *See also,* OFFICE OF FAIR TRADING, UNFAIR CONTRACT TERMS, BULL. NO. 4 at 6. (last modified Dec. 23, 1997), *available at* http://www.oft.gov.uk/html/rsearch/reports/oft202.htm (U.K. & E.U. law).

28. 357 N.Y.S.2d 951 (N.Y. Sup. Ct. 1974) (stating lease gave franchisor right to evict franchisee on 10 days notice).

29. *Id.* at 956 (quoting Printing & Numerical Registering Co. v. Simpson, 19 Law Rep. 462, 465 (1875)).

30. Philip F. Zeidman, *The Pacific Rim Revisited,* FRANCHISE TIMES, May 2003 at 59, 66 (noting that in 2001 there was little regulation in China, Korea, and Japan, but by 2003 that was changing).

statutory mandates must take into account regulatory capture and the nature of franchise contracts, which are inherently relational.[31] As the name suggests, relational contracts are contracts between parties anticipating continuation of a relationship following signing of the contract.

American legislation regulating franchise relationships in the petroleum industry[32] was spurred by the realization that the franchise contract "may translate the original disparity of bargaining power into continuing vulnerability of the franchisee . . . ."[33] The practices leading to regulation of auto and petroleum franchise relationships were ones arising from the fact that franchise contracts are relational contracts in which the franchisee's desire to protect the initial investment permits franchisor overreaching during the course of the franchise relationship.

Passage of years or decades will necessarily introduce unforeseen circumstances to which the parties must adapt. In franchising, the franchisor normally exercises discretion as to how the parties shall adapt. A 7-11 franchisee noted of acquiescence to franchisor demands, "You must understand that when one is trying desperately to save one's business, one's entire livelihood, you are willing to do almost anything."[34]

There is a difference between a discrete contract and a relational contract, and franchise contracts are a distinct subset of relational contracts. Application of the implied covenant of good faith and fair dealing is critical. Unlike a traditional contract, franchise contracts establish a relationship where the stronger party can unilaterally alter the fundamental nature of the obligations of the weaker party, and "[U]nfettered discretion [in an Agreement that gives one party sole discretion in a number of provisions] is precisely what the implied covenant of good faith was designed to deal with in spite of its seemingly unfettered discretion [the franchisor] must act in a commercially reasonable manner."[35]

Franchise attorney Andrew Selden coined the term "power

31. "Relational" was a term first used by Ian R. MacNeil. *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW U.L. REV. 854, 886 (1978). *See also* Charles F. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

32. Now codified as Petroleum Marketing Practices Act, at 15 U.S.C. §§ 2801–2841 (2004).

33. S. REP. NO. 95-731, at 17 (1978), *reprinted in* 1978 U.S.C.C.A.N. 873, 876.

34. Letter from Teresa Maloney, National Coalition of Associations of 7-Eleven Franchisees, to Secretary of the Federal Trade Commission, (April 27, 1997), *available at* http://www.ftc.govv/bcp/franchise/comments/final38.htm (explaining the ability of franchisors to force signing of general releases by franchisees).

35. Subaru Distributors Corp. v. Subaru of America, Inc., 47 F. Supp. 2d 451, 462 (S.D.N.Y. 1999).

franchising" to describe the traditional franchise model: "heavily one-sided contracts that lock the franchisee into an unknown future determined by the unilateral decisions of franchisor management."[36] By use of Operations Manuals, compliance audits,[37] contract renewal, and contractual collective action clauses (CACs), such as "agree to agree"[38] and "conform to current,"[39] the franchisor can exercise nearly total discretion over the franchisee. Multiple methods exist to alter the obligations of the parties, but CACs are particularly troubling because they render the franchise contract itself an ephemeral document drafted on an Etch-a-Sketch.

CACs can be a powerful tool to unilaterally alter the current and future obligations of franchisees who signed contracts decades in the past; effectively, the "parties" to the original contract include unknown future members to be admitted at the discretion of the contract drafter. CACs are found in debt instruments, where ability of CACs to alter contractual rights and obligations of the parties has been limited by state and federal legislation; no such protection exists to protect franchisees from CAC abuse. Franchisees who have never seen a CAC before are not likely to understand its impact until it alters their franchise contract. One franchisee association president confronted with unilateral franchisor alterations pursuant to an "agree to agree" clause said to his

36. Andrew C. Selden, *Organization Design for Successful Franchising*, 20 FRANCHISE L.J. 1 (2000).

37. Compliance audits may include subjective criteria, such as the cheerfulness of employees or cleanliness. Since the criteria are set by the franchisor and enforced by the franchisor, prudent franchisees will avoid challenging franchisor policies or joining franchisee organizations if they wish to minimize the risk of termination and the concurrent loss of their franchise investment.

38. Such a clause states that, notwithstanding the language of the signed contract, the franchisee "agrees to agree" to any change to the contract if a certain percentage of franchisees "vote" to change the provision. The franchisor then puts the provision in the contracts of franchisee applicants, who by purchase of the franchise are casting their "vote" in favor of the franchisor. Note that the subsequent franchisees are initially under the old provision and probably do not realize that they have "voted" until the new provision affects them. Moreover, the initial franchisee may not even be aware of the pending change unless the franchisee continually reads the new Uniform Franchise Offering Circulars. In a fast-growing system, or one growing off of a numerically small base, the franchisors' use of "agree to agree" clauses give the franchisor the ability to drastically change existing contracts. Since franchisees have no comparable tool, the franchise contract will shift in favor of the franchisor unless the franchisor chooses to surrender benefits.

39. Such a clause states that when the holder of a current franchise(s) purchases an expansion franchise or the franchise of a departing franchisee, all of the holder's franchise agreements will be amended to conform to the most current contract. Therefore, if a 50-unit franchisee buys another unit, not only will all 51 contracts have the new obligations, but 51 "votes" have been cast to change the obligations of *all franchisees in the system* subject to contractual alterations proposed pursuant to "agree to agree" clauses.

fellow franchisees, "All of it is legal; we've already checked that out! But, it stinks."[40] Collective action is a one-sided affair; the same franchise system prohibits class-action lawsuits by franchisees.

Wealth transferred to the franchisor includes not only the direct fees paid by the franchisee, but the diminution of the value of the franchise under the new contract. The nature of franchising itself is that the franchisee is "buying" something that the franchisee can never sell, specifically, the trademarked "name on the door" and such support as the franchisor chooses to provide. Unsophisticated buyers of franchises fail to realize the implications of the fact that they are licensing a trademark, and are dependant on the good faith of the franchisor not merely during the course of their affiliation with the franchisor, but in exiting the system as well.[41] A franchise is a wasting asset, and as franchisees approach the expiration of their term they are subject to franchisor pressure to show a "sense of team work" as a condition of franchise renewal.[42] In short, "the franchise relationship provides ample opportunity for a large corporate franchisor to take unfair advantage of a small franchisee who is dependent on the franchisor for its business."[43]

Even if franchisor discretion is not used to extract wealth from the captive franchisee, the franchisor has sole control over new franchise agreements, and in virtually all cases, the existing franchisee can only sell to a new franchisee who has signed a new, more onerous franchise agreement. Assuming the new franchisee to be an economically rational actor, the franchise will have a reduced value due to the contract's more onerous nature (higher royalties,[44] supra-competitive pricing of supplies,

40. Jim Hatfield (North American Association of Subway Franchisees), *Reporting Back: SAC News*, 1 NAASF NEWSWIRE 4, at 1 (2002). CACs are particularly troubling in franchise contracts; purchasers of a bond issue realize they are governed by a single trust indenture, but purchasers of a franchise enter into individual contracts which are subsequently altered to conform to the franchisor's ever-changing master template.

41. This is due to the fact that operation of the franchise necessarily involves use of the franchisors marks. This applies not only to voluntary transfers but to bankruptcy transfers as well. *See* Piercing Pagoda, Inc. v. Hoffner, 351 A.2d 207, 211 (Pa. 1976). *See generally* Neil S. Hirshman, Michael G. Fatall, & Peter M. Spingola, *Assignability of Intellectual Property Licenses in Bankruptcy*, IPL NEWSL., Fall 2002, at 11, 13 (stating that assignment without consent is not permitted since the trademark owner has duty to maintain goodwill associated with mark). With less well-known trademarks, the primary purchase motivation may indeed be the business know-how of the franchisor. However, the top franchises, such as McDonalds, Subway, and 7-11, sell to individuals who are paying for the mark which drives traffic; without the mark, franchisor "know-how" is of little value.

42. *Cf.* Zuckerman v. McDonald's Corp., 35 F. Supp. 2d 135, 138 (D. Mass. 1999).

43. Piantes v. Pepperidge Farm, Inc., 875 F. Supp. 929, 938 (D. Mass. 1995).

44. *Cf.* Timothy's Coffees of the World Inc. v. Switt, 94-CQ-050117, 1996 Ont. C.J. LEXIS 2543 at *5 (Ont. Ct. General Div. 1996) (discussing royalty increase from 6% to 9% in the new (renewal) franchise agreement).

expensive remodeling requirements, etcetera). Franchisee costs can be significant; in September 2003, McDonald's announced a remodeling program estimated to exceed $1 million per store. McDonald's—one of the largest real estate owners in the world—also announced that franchisees would no longer be permitted to own the building which housed their restaurant. This prompted the chair of the franchisee National Leadership Council to remark:

> We do not believe that in the history of commercial real estate a lessee has been responsible to pay for rebuilding and then pay more to lease it [from the lessor] in the future. And we don't want to be the first to set that precedent.[45]

Franchisor discretion presents a mechanism for post-sale abuse, and a distinction must be drawn between a prospect's lack of legal sophistication and the operational sophistication a franchisee obtains by being in daily contact with the retail consumers of the franchised product. The assumption implicit in many judicial rulings is that the franchisor knows best and is acting to maximize the value of the franchised business. This assumption does not accord with the short-term skew of modern compensation schemes. In many cases, it is the franchisees who come to have a longer tenure than franchisor executives. Industry consultant, Professor Kornblau, remarked that franchisee commitments may be for 20 years, but few franchisor executives will last that long; "franchisees need and deserve commitments for a focus that is beyond the bonus year."[46] The revolt of Shakey's franchisees in the late 1990's was due in part to franchisor mismanagement of the brand, with

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45. Amy Garber, *McD Operators Lovin' New Image, Angry Over Rebuild*, NATION'S RESTAURANT NEWS, Sept. 15, 2003 at 1, 84.

46. Len Kornblau, *Chains Must Create Marketing Plans That Benefit Franchisees Over the Long Haul*, NATION'S RESTAURANT NEWS, Oct. 7, 2002 at 24, 56. At one point, Burger King franchisees even broached the idea of taking over the brand from incompetent management under Diageo PLC. James Peters & Amy Zuber, *BK Franchisees Halt Growth Plans, Say Brand Must Beef Up*, NATION'S RESTAURANT NEWS, June 25, 2001 at 3, 207. *See also* Richard Behar, *Why Subway Is "The Biggest Problem in Franchising,"* FORTUNE, Mar. 16, 1998 at 126, 128 (explaining that Subway development agents offered $1.5 billion to buy-out founder who they felt was mismanaging the brand). In Quebec, 10 Dunkin' Donuts franchisees sued, alleging losses due to franchisor mismanagement. Lori Lohmeyer, *Allied Domecq Dunks Corporate Staff in Restructuring*, NATION'S RESTAURANT NEWS, Aug. 25, 2003 at 4, 85. Royal Capital, the largest franchisee of beleaguered Church's Chicken, hired the franchisor's CFO and reportedly is negotiating to buy the franchisor. Jack Hayes, *Exit of Church's CFO Fuels Speculation About Chain, AFC's Future*, NATION'S RESTAURANT NEWS, Sept. 15, 2003 at 1, 85. Franchisees bought Fantastic Sam's after the franchisor went bankrupt after using Sam's revenue to pay for a failed acquisition strategy. *Franchisee Group Takes Over at Fantastic Sam's*, FRANCHISE TIMES, Oct. 2003 at 24.

Shakey's having "a revolving door to the executive office."[47] In contrast, the president of Shakey's franchisee association began working in his father's franchise at the age of 8, and noted that his hard work had left him appreciating the small value of the hard assets.[48] It is not franchisors who bear the brunt of their own failure, as Congressman Coble (R-NC) explained:

> When speaking to this point of franchisor power and abuse, you don't have to look any further than the horse's mouth. A major franchisor indicated in a recent press release that 'to alleviate its debt load and boost stagnant sales' the company would be shifting more burden onto its franchisees. Did the franchisees have a say in this decision? Probably not. Nonetheless, the franchisor has the unilateral power and right to dump or to transfer its burden onto the franchisees.[49]

Finally, this paper addresses the current regulatory scheme in the United States and pending proposals for reform. A brief overview may assist readers unfamiliar with this issue: both state and federal government agencies enforce regulations applicable to franchising, although their efficacy is a matter of considerable debate within the franchise community. At the federal level, there is a Franchise Rule promulgated by the Federal Trade Commission (FTC).[50] This governs the pre-sale period and essentially requires the franchisor to deliver to prospective purchasers a document known as a UFOC[51] containing information about the franchise. The FTC proposed changes to the Franchise Rule[52] governing pre-sale conduct at the same time that Congress was proposing legislation known as the SBFA[53] which would govern post-sale conduct. At times, the debate over FTC regulation

47. Amy Spector, *Shakey's Franchisees Stirred Up Over Claims of Franchisor Neglect*, NATION'S RESTAURANT NEWS, Apr. 16, 2001 at 4 (noting more than six different franchisor owners in 47-year history of chain).

48. *Id.* at 4, 96. There is the McDonald's team which pursued a failed price war and disastrous brand diversification strategy, but when pushed out by the Board was given a generous severance package. Fortunately for franchisees, the new management is having more success.

49. *Franchising Relationship: Hearing Before the Subcom. On Commercial, & Administrative Law of the Committee on the Judiciary*, 106th Cong. Serial No.106-92 at 17 (1999), *available at* http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0.htm (hereinafter, *Franchising Relationship*) (prepared statement of Hon. Howard Coble (R-NC)).

50. 16 C.F.R. § 436.1 (2004).

51. Uniform Franchise Offering Circular. This document resembles a stock prospectus, only much longer.

52. *See* http://www.ftc.gov/bcp/franchise/rulemkg.htm (notice, public comments, and press releases).

53. SBFA stands for Small Business Franchise Act, which is also known as the "Coble-Conyers" after the sponsors. The most recent incarnation was as HR 3308 in the 106th Congress.

resembles kabuki theatre: things are not what they seem. Franchisors point to the Franchise Rule in support of the proposition that there is sufficient regulation of franchisors, when in fact most franchise disputes arise in the post-sale period, which the FTC chooses not to regulate despite the existence of Section 5 authority to do so.

Although the FTC debate is often a proxy for debating Congressional legislation, the two are entirely separate issues, both as a matter of law[54] and in their effect[55] on franchising. The FTC is an agency of the executive, whereas Congress is part of the legislative arm of the U.S. federal government. Lawyers sometimes get the branches of government confused; when the FTC solicited comments on the *Franchise Rule*, the American Bar Association Section of Antitrust Law submitted a lengthy brief[56] on the proposed *Congressional legislation*. This prompted the American Franchisee Association[57] (AFA) to submit a rebuttal that began by noting the obvious conceptual (not to mention legal) flaw in the lawyers' position.[58] As this paper shall demonstrate, the ABA brief is not the only example of franchise law discourse which is sclerotic,[59] intellectually dishonest,[60] and blind to the realities of the

54. SBFA is a federal law; the FTC Rule is accorded deference, but it is not a statute. *See, e.g.*, Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 104 S. Ct. 2778 (1984)

55. SBFA would significantly alter the post-sale relationship; FTC's Franchise Rule covers pre-sale delivery of a compliant UFOC.

56. REPORT OF THE AMERICAN BAR ASSOCIATION SECTION OF ANTITRUST LAW ON PROPOSED SMALL BUSINESS FRANCHISE ACT, *available at* http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment025.htm. The ABA has historically opposed federal franchise legislation. *ABA Adopts Resolution Opposing Franchise Bill*, 852 ANTITRUST & TRADE REG. REP. (BNA) A-15 (Feb. 23, 1978).

57. http://www.franchisee.org.

58. Letter from Susan P. Kezios, AFA President, to Donald S. Clark, FTC Secretary (January 31, 2000), *available at* http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment037.htm.

59. Contract law principles in franchising harken back to turn-of-the century decisions, such as *Lochner v. New York*, 198 U.S. 45 (1905), in invoking the "freedom of contract" mantra, and in the "classical" formalism applied to eliminate the obligation to deal in good faith. *Cf.* Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223, 1231-1236 (1999) (stating that recent retrograde "plain meaning" jurisprudence reflects view of good faith covenant at odds with trend since adoption of UCC). Existing in the wider legal arena, these are particularly acute issues in franchising.

60. Notwithstanding industry claims that UFOC disclosure is sufficient and that franchisees are sophisticated businesspersons, many franchisors admit that franchisees buy with their hearts, do not even read the UFOC, do not comprehend the scope of franchisor discretion *ex post*, and are viewed by franchisors as ignorant children who need a firm hand and are expendable in the event that they seek to attain any semblance of bargaining power. One of the authors sat through a presentation in Philadelphia by a franchisor of tobacco shops as the President deprecated his franchisees for almost an hour, and discussed using the franchisees to funnel business to the franchisor internet site. When asked about the impact of *Drug Emporium* (Bus. Franchise Guide (CCH) 11,966),

franchise relationship: such can be seen in the areas of encroachment, sourcing, good faith/fair dealing, and so-called "renewal" of the franchise, to name just a few.

There are many instances of franchisees breaching the franchise contract, failing to pay royalties due,[61] and damaging the trademark to the detriment of their fellow franchisees,[62] as well as occasional franchisee opportunism,[63] but this paper will focus primarily on instances of franchisor opportunism. Although there are some franchisees with power over their franchisors,[64] this is not normally the case, and corporate franchisees and franchisors have the financial resources to ensure a level playing field.[65] Furthermore, American franchising law (and the trend of global franchising law) favors the protection of franchisor interests. There are also major law firms representing franchisors with sections specializing in Franchise and Distribution Law. However, those representing franchisees are far fewer in number, leading to an imbalance in legal scholarship.[66] Additionally, franchisor-side

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the franchisor pointed to two attorneys in the room and said neither law firm had responded to his request for a means of "getting around" the decision. Turning to the female attorney, he said "Maybe the two of you could wrestle to see who gets my business."

61. Failure to pay royalties and other debts is often an indication of financial difficulties, and ultimately will lead to termination. For this reason, franchisors determined to get rid of a franchisee will often use economic pressure such as onerous remodeling/maintenance demands or punitive encroachment, as this paper will discuss.

62. *E.g.*, *Spitzer Getting Inn-Volved*, N.Y. POST, Aug. 6, 2002, at 11 (stating that discrimination against Orthodox Jews by Days Inn franchisee in Catskill, New York caused cancellations at unrelated Days Inn in Liberty, New York, and negative publicity, including investigation by New York Attorney General Eliot Spitzer). A few days later, the franchisee was terminated. *See* Kenneth Lovett, *It's Checkout Time: Days Inn Boots 'Bias' Motel*, N.Y. POST, Aug. 16, 2002 at 16.

63. Synergism Arithmetically Compounded, Inc. v. Parkwood Hills Foodland, Inc., 8 C.P.R. (4th) 135, 2000 C.P.R. LEXIS 181, at *26 (Ontario Sup. Ct. of Justice 2000) (finding franchisees took advantage of bankrupt franchisor, and attempted to renegotiate agreements, and withhold royalties and ad fund monies).

64. *See* Alan J. Liddle, *Unhappy Shakey's Franchisees Say Control of Chain at Stake in Lawsuit*, NATION'S RESTAURANT NEWS, Jan. 20, 2003 at 4.

65. *Cf.* ROBERT A. KAGAN, ADVERSARIAL LEGALISM: THE AMERICAN WAY OF LAW 122-125 (Harvard Univ. Press 2001) (showing effect of wealth on outcome, repeat-player effect, and ADR as "purchase" of justice). Corporate franchisees may be wealthy; in the recent fight for corporate franchisee Quality Dining (NASDAQ: QDIN), the franchisee spent one million dollars to fend off a takeover bid by a group of fellow Burger King franchisees. Julie Bennett, *Families Wage Battle for Quality Dining*, FRANCHISE TIMES, Sept. 2000 at 16.

66. A notable exception is the multi-volume FRANCHISING: REALITIES AND REMEDIES, originally authored by the late Harold Brown, and currently edited by J. Michael Dady, Jeffery Haff, and Ronald Gardner. The imbalance is also seen in legal academia, with the exceptions of Professors Warren Grimes and Gillian Hadfield. Professor Jean Sternlight has also written about problems with arbitration clauses in franchise agreements.

counsel represent their clients in franchise disputes in which the issues vary little from case to case, while franchisees often use a local attorney who may have never previously litigated a franchise case.[67]

Franchisors also have enormous monetary and legal resources. McDonald's, criticized by two impoverished private citizens who refused to apologize to the mighty franchisor, launched the longest-running lawsuit in the history of Great Britain—at a cost of £ 10 million.[68] In the United States, both Burger King and Subway have fought franchisees all the way to the Supreme Court; the franchisees lost.[69] In one Subway case, the franchisee lost his store and his loan collateral. In another case, Subway prevailed against one franchised outlet and submitted a legal bill of over $400,000—far more than the value of the franchise that was the subject of the litigation.[70] Both Burger King and Subway have since made significant steps toward a more amicable relationship with franchisees. This does not change the history lesson for future franchisors; a multibillion dollar corporation can be built with little regard for the welfare of the thousands of individuals who invest their life savings to build the franchisor's brand.

Franchisors have the resources to make an example of those who would challenge their interests. By accessing the labor and capital markets with a franchise business model, franchisors are able to achieve freedom from statutes which would otherwise protect workers and investors. Franchisees have far more to lose than hourly employees, and it is not surprising that so many franchisees are reluctant to join associations; the American Franchisee Association has an "Anonymous" membership category for franchisees fearing retaliation. In contrast, large franchisors such as Wendy's, McDonald's, Burger King, and Yum! Brands have full-time government affairs staff to lobby legislators and regulators.[71] The International Franchise Association (IFA) is

67. The Australian Franchise Association attempted to provide a mechanism for the information exchange of discovery documents among franchisees, similar to the ATLA Exchange maintained by American tort lawyers. This was found to be a violation of Australian law. Magic Menu Systems Pty Ltd v. AFA Facilitation Pty., No. QG 73 of 1996, 1997 Aust. FedCt LEXIS 4 at *12 (Fed. Ct. of Australia, Gen. Div.). The court said, "we do not suggest that practices in the [U.S.] would necessarily, or even likely, be viewed as desirable [in Australia]." *Id.* at *19. It should be noted that the Association followed some dubious practices which account for some of the tenor of the decision.

68. JOHN VIDAL, MCLIBEL 6 (1997). *See also* http://www.mcspotlight.org.

69. Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985); Doctor's Associates, Inc. v. Casarotto, 517 U.S. 681 (1996).

70. Joe Dwyer, *David Duree Fined $408,445, Barred in Kansas*, ST. LOUIS BUS. J., June 14, 1996, *available at* http://www.bizjournals.com/stlouis/stories/1996/06/17/story5.html. The saga of David Duree and the Subway sandwich franchise is something akin to Ahab and the Whale, but regrettably beyond the scope of this paper.

71. Ellen Koteff, *Joining Government-Affairs Parade Allows Operators to Beat*

headquartered in Washington, where it lobbies Congress to oppose regulation of franchising;[72] the IFA gave money to 33 candidates in the 2002 Congressional race.[73] The IFA has spent more than $200,000 filing more than a dozen *amicus* briefs in court cases.[74] IFA lawyers told the U.S. Supreme Court that *amicus* briefs are helpful since IFA is "a trade association for the franchise industry [concerned with] the broad impact which this Court's decision may have upon that industry.[75] The IFA believes that the franchise industry perspective and experience will be helpful in assessing that impact."[76] However, when speaking with lawmakers seeking to regulate the industry, IFA lawyers deny that franchising is an industry.[77]

The "IFA works closely with the Federal Trade Commission, Congress, state legislators and regulatory agencies to ensure that the laws and regulations are conducive to the unique marketing concept of franchising."[78] The president of the American Franchisee Association (AFA) observed that "[t]he prior failure of [franchise] bills in the U.S. Congress says little about the merits of such legislation, and more about the financial and political clout" of those opposing the legislation.[79]

Financial issues aside, franchisors can and do protect their interests to an extent which is not possible for franchisees under current law. As one Australian franchisee testified:

> I came to realize that my future security and prospects in the

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Their Drums, Save Money, NATION'S RESTAURANT NEWS, Dec. 2, 2002 at 28.

72. Robin Lee Allen, *IFA Holds First Blitz on Capitol Hill: Franchisors, Franchisees Lobby to Blunt New Regulatory Momentum*, NATION'S RESTAURANT NEWS, Nov. 1, 1999 at 1 ("[F]irst organized lobbying blitz" by IFA in attempt to stop proposed fair franchising law).

73. Paul Frumkin, *GOP Victory Seen as Win For Industry*, NATION'S RESTAURANT NEWS, Nov. 18, 2002 at 1, 6.

74. Janet Sparks, *"Best and Brightest" Discuss Issues at IFA Symposium*, FRANCHISE TIMES, June-July 2000 at 24 (quoting IFA government affairs director Betsy Laird).

75. Brief of Amici Curiae International Franchise Association, Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977), *available at* 1977 WL 189273 at *1.

76. *Id.* at *3. *See also* Redevelopment Agency of the City of Concord v. Int'l. House of Pancakes, 12 Cal. Rptr. 2d 358, 360 n.2 (1992) (*amicus* brief filed by IFA "the national trade association of the franchising industry").

77. Amy Spector, *Tricon Mounts Taco Bell Bailout: Store Buybacks, Debt Waivers Eyed as 'Refranchising' Criticized*, NATION'S RESTAURANT NEWS, Feb. 26, 2001 at 1, 41 (quoting Matthew Shay, general counsel for IFA, opposing legislation on grounds that "franchising is not an industry, it's a business concept used by industries"); *see also Franchising Relationship*, *supra* note 49, at 93 (statement of Dennis E. Wieczorek, Esq., Partner, Rudnick & Wolfe).

78. *Networking In, Participating In, Joining In . . . International Franchise Association* (Brochure, undated) (on file with author).

79. Susan P. Kezios, *Small Business Franchise Act Eyes Protecting Franchisees, Not Hindering Competition*, NATION'S RESTAURANT NEWS, Aug. 14, 2000 at 32, 36.

> McDonald's System, being my [Aust.] $2 million plus investment in my restaurants and my desire to expand, were ultimately in the hands of a very subjective evaluation of my restaurants by one or two people and the personal relationship [with] my Consultant.[80]

Alexander Hamilton observed: "In the general course of human nature, a power over a man's subsistence amounts to a power over his will."[81] The nature of franchise contracts is such that there is necessarily ambiguity, and the franchisors have the ability to unilaterally change the obligations (and economic viability) of the franchise relationship over a term that may last for 20 years. Discussing New Jersey's Franchise Practices Act, the state Supreme Court noted the "community-of-interest" in the franchise relationship which, coupled with an inequality of bargaining power, is "critical in distinguishing franchises from other types of businesses."[82] The court explained:

> [O]nce a business has made substantial franchise-specific investments it loses all or virtually all of its original bargaining power regarding continuation of the franchise. Specifically, the franchise cannot do anything that risks termination, because that would result in a loss of much or all of the value of its franchise-related investments.[83]

A Canadian court took note of sunk costs as reason to limit post-sale exercise of franchisor power:

> From the franchisee's point of view, he must continue to provide a useful function for the franchisor in the nature of those birds who clean the teeth of crocodiles. On the other hand, most good franchisors recognize that they are in a long-term relationship and therefore do not immediately clamp their jaws down on a franchisee who makes one or two errant pecks at the food. This of course is a question of degree. However, in my mind, it appears that the crocodile should become increasingly tolerant with the longevity of the relationship and the amount of non-liquid assets that the bird has at stake.[84]

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80. Far Horizons Pty Ltd. v. McDonald's Australia Ltd., 2257 of 1996 (Sup. Ct. of Victoria, Commercial & Equity Division, Aug. 18, 2000) (LEXIS, Commonwealth Cases Library, Victorian Unreported Judgments).

81. THE FEDERALIST No. 79, at 1 (Alexander Hamilton).

82. Instructional Systems, Inc. v. Computer Curriculum Corp., 614 A.2d 124, 140 (N.J. 1992).

83. *Id.* at 141. *Accord* In the Matter of Headquarters Dodge, Inc., No. 92-1030, 1992 U.S. Dist. LEXIS 18640, at *42 (D. N.J. Nov. 25, 1992) (Statute's "primary objective—to prevent the unfair forfeiture of a franchisee's investment that historically accompanied franchise termination.").

84. Head v. Inter Tan Canada Ltd., [1991] Ont. Sup. C.J. LEXIS 592, at *21 (Radio

Courts wary of franchisor opportunism have used doctrines such as the implied covenant of good faith and fair dealing to attempt to achieve an equitable solution to franchise litigation. However, as this paper shall demonstrate, this current American doctrine permits franchisors to draft contracts so as to eliminate the application of the implied covenant. Notably, the Petroleum Marketing Practices Act, "enacted in response to industry-wide abuses,"[85] explicitly provides for remedies traditionally deemed equitable. The PMPA has successfully withstood the withering of the covenant of good faith and permitted the continued health of the gas station franchisors. Unfortunately, only auto and gas franchisees have such protection in all United States jurisdictions.[86]

This paper proposes that federal regulation include termination provisions; in states without franchise legislation, common law principles apply. At common law, as one treatise notes, "effects of termination were starkly simple—the franchisee would be ousted from the franchise, essentially forfeiting his investment . . . the franchisor would then regain full control of the terminated business and would be free to begin a relationship with a new franchisee."[87]

As added risk to the franchisees, default of one franchise agreement may result not only in termination of the franchise at issue, but—due to cross-default clauses—result in declaration that the franchisee is in default of all the franchisee's agreements. To circumvent the protections of the corporate form, franchisors require that the franchisee sign the contract as a natural person. Even where the franchisor subsequently assents to the assignment of rights to the franchisee's corporate entity, the franchisee must remain personally liable, and the franchisor will specify that as between the franchisor and franchisee the relationship is with the franchisee as a natural person.[88] As a result, franchisees cannot segregate their different franchises, nor can they segregate their personal from their business assets. The franchisor remains protected by the corporate form, and can set up separate entities.[89] As a result, the

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Shack franchisee).

85. Daras v. Star Enterprise, No. HAR 91-480, 1992 U.S. Dist. LEXIS 17831, at *7-8 (D. MD Nov. 12, 1992).

86. *Cf.* Jan S. Gilbert, *The FTC Rule and the PMPA: An Uncertain Alliance*, 19 FRANCHISE L.J. 58 (1999) (FTC Franchise Rule does not provide relationship protection as does PMPA).

87. 62B AM JUR 2D *Private Franchise Contracts* § 548 (1999).

88. Andrew A. Caffey, *Secondhand Store*, ENTREPRENEUR, Dec. 2000 at 130, 132.

89. Franchisors using the corporate form can generally limit liability, with rare exceptions. *See generally* Richard M. Asbill & W. Andrew Scott, *Meineke Revisited: The Specter of Individual Liability*, 19 FRANCHISE L.J. 6 (1999) (cases where franchisors personally liable). Claims of intentional misrepresentation may give rise to claims against individuals associated with the franchisor, particularly in the absence of "skillful drafting" of the franchise agreement. Richard C. Duell III, *Personal Liability: Are You at*

franchisor seeks to terminate the franchisee, it can arbitrate on its home ground while seeking *judicial* eviction of the franchisee from the franchise premises on grounds which relate to default under the franchise agreement subject to an *arbitration* clause.[90]

II. Pre-Sale Issues

A. Fictive Kinship: The Franchise "Family"

Henry Ford told the U.S. Senate that a franchise relationship was like a marriage.[91] Invoking fictive kinship to lower innate distrust of strangers goes back to the beginnings of recorded history.[92] The theme was taken up by franchisors in the 1960s and '70s: "The role I've got is the Daddy, and the role you've got is the son."[93] A more accurate analogy is of the virginal bride (franchisee) and experienced groom (franchisor).[94] Marriage is a form of relational contract, and the analogy is useful in understanding not only the franchise relationship, but also the degree to which legal constraints (such as the SBFA) can limit opportunism in the relationship. The analogy also suggests why non-legal constraints cannot sufficiently regulate the franchise relationship.

Risk?, FRANCHISE TIMES, Aug. 2001 at 48. Limited liability first appeared at Florence in 1408. *See* J.M. ROBERTS, THE PENGUIN HISTORY OF THE WORLD 499 (1992).

90. The practical effect is that the franchisee must arbitrate in the franchisor's chosen forum but the franchisor can either arbitrate and/or bring litigation. The Subway franchisor has used separate corporations and forum selection clauses to maximum effect. *See* Edward Wood Dunham, *Enforcing Contract Terms Designed to Manage Franchisor Risk*, 19 FRANCHISE L.J. 91 (2000) (Dunham is outside counsel for Subway).

91. THOMAS S. DICKE, FRANCHISING IN AMERICA 82 (1992).

92. ROBERT WRIGHT, NONZERO: THE LOGIC OF HUMAN DESTINY 101 (2000) (correspondence from third millennium B.C. between king of Ebla and king of Hamazi). *See also* PINKER, *supra* note 25 at 245-47 (providing historical and literary examples; citations to cognitive studies supporting theory).

93. Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 964 (1990) (*quoting* John Jay Hooker, *The Story of Minnie Pearl: A Case History of One New Company's Trials, Translations, and Triumphs, in* FRANCHISING TODAY: REPORT ON THE FIFTH INTERNATIONAL MANAGEMENT CONFERENCE ON FRANCHISING 176 (1970) [hereinafter FRANCHISING TODAY]).

94. *Id.* (*quoting* Ken Coomer, *Three Recurrent and Acute Major Problems in Franchising, in* FRANCHISING TODAY 184). As franchise operators, the authors have heard such analogies. There is a reported case of a franchisee who testified the franchisor spoke of plans to "f**k" the franchisee. *See* Far Horizons Pty Ltd. v. McDonald's Australia Ltd., 2257 of 1996 (Sup. Ct. of Victoria, Commercial & Equity Division, Aug. 18, 2000). At least in the U.S., f**k has entered popular usage. *See* Alexandra Jacobs & Maria Russo, *It's a Four-Letter Summer*, N.Y. OBSERVER, July 7-14, 2003, at 1, 8 (noting first TV usage on BBC in 1965, uncensored on live TV on NBC in Jan. 2003, and recent usage by President Bush and Senator Hillary Clinton). Indeed, "One man's vulgarity is another man's lyric." Cohen v. California, 403 U.S. 15, 25 (1971). *See also* Winslow *supra* note 5 (describing franchisees being "screwed").

Citing the example of the virginal franchisee bride, Professor Eric Posner states that not only are such "fictive kinship" relationships difficult to regulate judicially, but so are more discrete contractual relations.[95] The conclusion Posner draws is that "[m]uch contractual behavior depends on reputation, ethnic and family connections, and other elements of nonlegal regulation and not on detailed and carefully written contracts enforced by disinterested courts."[96] A question unanswered by Posner is whether franchisors lacking kinship with franchisees are constrained from opportunistic behavior by any non-legal regulation. Indeed, law and sociology have become intertwined for just this reason; as the "kinship circle" both expands and becomes less personal, so the law expands to recognize an obligation to that circle.[97]

A large franchisor with hundreds or thousands of outlets is unlikely to feel any ethnic or family connections.[98] If we expect franchisors to obey the mores embodied in other areas such as the securities marketplace (which is emphatically not laissez-faire) then we must codify that expectation in franchise relationship legislation. There are only two segments of the American franchise industry which have significant statutory protection: auto and petroleum franchises. Both segments were the earliest to engage in national franchising, and many of the automobile dealerships were owned by well-off leaders of the local business community. And while the auto dealers were powerful enough to spur Congressional action, the widespread franchisor abuse which

95. ERIC A. POSNER, LAW AND SOCIAL NORMS 152-53 (2000).

96. *Id.* at 153; *accord*, Erin Ann O'Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law*, 53 VAND. L. REV. 1551, 1593 n.173 (2000).

97. An early example of this can be seen in the Roman Catholic Church, which originally linked the sacred and the profane at law; an outgrowth of the Christian view of the ecclesia. *See generally* HAROLD J. BERMAN, LAW AND REVOLUTION: THE FORMATION OF THE WESTERN LEGAL TRADITION (1983). The thousand-year old severing of ecclesiastical from secular law was both a product of and a contributor to the rise of nation-states. However, by 1625 Hugo Grotius' *De Jure Belli ac Pacis Libri Tres* (The Law of War & Peace) recognized that individual states—and by extension, individuals—owed a legal obligation to others. The ineffectiveness of non-legal constraints in such a world necessitated the birth of international law. The concept of an expanding circle of kinship has received increasing study recently, particularly with the rise of multilateral treaties and issues of global concern such as the environment, terrorism, and drug trafficking. To say that we are all in the same boat is also to recognize that the "boat" has grown from a 2-person canoe to a massive ocean liner. Posner is correct in his initial analysis, but as he fails to see this expanding kinship circle, he fails to see the jurisprudential implications. The expanding kinship argument was most notably made by Peter Singer. *See* PETER A.D. SINGER, THE EXPANDING CIRCLE: THE ETHICS AND SOCIOBIOLOGY (1981). *See also*, PINKER, *supra* note 25, at 165-69, and WRIGHT, *supra* note 92.

98. However, the author Paul Steinberg notes that when co-author Gerald Lescatre passed away suddenly, the personnel of Subway were both kind and of invaluable assistance, for which he remains grateful.

triggered the legislation indicates that franchisors are not too concerned about damage to their reputations; even where the franchisors are few in number and hence more readily identifiable in the public mind. Regulation of petroleum-industry-franchisors came in the wake of the oil crisis, when anti-oil sentiment reduced the efficacy of big oil lobbying efforts. From that time until today, no further franchise relationship legislation has passed in Congress.

Today there are thousands of politically active franchisors. At the same time, many of the franchisees are immigrants unlikely to engender much empathy in the local community or on Capitol Hill. The sheer numbers make it less likely that bad behavior by franchisors will be widely publicized. Constraints based on reputation are predicated on an efficient market that provides ready access to reputation information. Given that only those franchise disputes meeting specific criteria are disclosed in a UFOC,[99] and that a search of public databases will not disclose arbitrations,[100] the written record available to a prospective franchisee contradicts Posner's conclusion. Additionally, game theory posits that bad behavior will affect ongoing dealings between the parties in a tit-for-tat retaliation. The problem is that once the franchisee has signed the franchise agreement, costs and growing inequality in bargaining power precludes retaliation against the franchisor. Hence, neither the intra-party nor the external impacts on reputation predicted by classical game theory are effective in franchising.

Let us assume that the foregoing impacts did exist, or that a franchisor believed them to exist. Such a franchisor might be thought to be constrained by concerns about reputation, but as Posner should admit, opportunistic behavior in such a situation may result in a sophisticated franchisee imputing a high "discount rate"[101] to the franchisor. In theory, the franchisor would have to make the franchise more economically attractive to the franchisee. Alternatively, the franchisor might seek out less sophisticated buyers who would be less likely to understand the risk.[102] Even if risk were perceived, less sophisticated buyers would assign greater utility to the franchise opportunity due to their own lack of

99. BUSINESS FRANCHISE GUIDE ¶ 6237 (Commerce Clearing House). This information disclosed in Item 3 of the UFOC. Under the 1999 Notice of Proposed Rulemaking, the FTC would expand the circumstances in which UFOC disclosure would be required.

100. One partial source of arbitration decisions is the Business Franchise Guide, published by Commerce Clearing House (CCH).

101. Where "discount rate" is an assessment of the reliability of the other party as a partner in a relationship. *See* POSNER, *supra* note 95, at 17, 19.

102. *See generally*, PETER L. BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK (1996) (discussing risk-taking behavior).

wealth.[103] Further, even if some negative consequences to the franchisor resulting from franchisor opportunism are assumed, society may be willing to excuse actions viewed as violative of public policy provided the offender has sufficient wealth.[104] Economic disparity between the parties arguably makes the concept even more repugnant.[105]

Constraints by reputation operate both internally and externally. In 1937, Karen Horney's *The Neurotic Personality of Our Time* viewed the tension between American economic values and American moral values from a psychoanalytic perspective; today we might describe the tension as cognitive dissonance. Much had changed by 2000 when Eric Posner wrote *Law and Social Norms*. Posner views reputational constraints as external, economic, events. From a Horney perspective, self-restraint suggested by internal considerations ("I am a good person; therefore I do not take advantage of my franchisees") may operate in a small system such as the Car Wash Guys franchise.[106] The Johnny Carino's franchisor placed a franchisee on its Board of Directors to provide input,[107] and Checkers Drive-In Restaurants selected as CEO a man who had been a franchisee of KFC, Taco Bell, and Papa John's Pizza to turn the company around and restore good relations with franchisees.[108]

At an IFA Legal Symposium, several counsel to small franchisors indicated to the authors that they were not comfortable with the harsh stance of the larger franchisor-members of the IFA and NFC, finding the attitude counterproductive both in intra-system relations and in the resultant legislative concern. However, large franchisors and franchisor lobbyists have the money and access to legislators. Where internal constraints are lacking, only the economic constraints suggested by

103. *Id.* (referring to the work of Daniel Bernoulli (1738); utility of increase in wealth inversely proportional to wealth possessed).

104. In the famous words of Sir Henry Maine, the history of the law has been "From Status To Contract." A byproduct of this has been an increasing unwillingness to permit those with superior resources to be above the law. At one time, even murder was permissible if one could pay the *wergild*. *See* Daniel Klerman, *Settlement and the Decline of Private Prosecution in Thirteenth-Century England,* 19 LAW AND HIST. REV., 1, 5 (2001). Wealthy franchisors have far more leverage than the average franchisee, and it is for the legislative branch to determine as a matter of public policy whether statutory curbs are needed. Such curbs would be in accord with the historical path of law in protecting the interests of a weaker party.

105. *Cf.* Ortwin Renn, *The Social Arena Concept of Risk Debates*, *in* SOCIAL THEORIES OF RISK, 179-96 (Sheldon Krimsky & Dominic Golding eds., 1992) (societal norms underlying the principle of inconvertibility of differing resources such as money in exchange for legal rights or legislation).

106. Winslow *supra* note 5.

107. *Fired Up Inc. names franchisee to board*, NATION'S REST. NEWS, Sept. 17, 2001, at 108.

108. James Peters, *Rebounding from checkered past, drive-in chain cuts debt*, NATION'S RESTAURANT NEWS, Sept. 17, 2001 at 4.

Posner are potentially available. Posner's analysis fails to explain franchisor behavior because Posner fails to take into account the realities of corporate behavior. Imperfect information exchange and targeting of unsophisticated purchasers limits the reputational constraint anticipated under traditional economic theory. Neuroeconomics suggests limits to the application of the rational actor model even in a rigorous disclosure regime.

Franchisees are impacted by decisions made thousands of miles away. The constraining influence of non-judicial (e.g., reputational) norms on behavior are inversely proportional to the degree of kinship. This realization spurred the development of written law itself.[109] Geographic distance gives rise to an emotional distance, replacing communal social norms with the artful drafting of franchisor attorneys. Franchisors make decisions pursuant to corporate policies and objectives,[110] whereas many franchisees are sole proprietors who operate their businesses as an extension of their personality. Posner's analysis, rooted in sociobiology,[111] does explain seemingly irrational behavior on the part of individual franchisees. One commentator noted "[t]he development of the norms, the existence of the behavior, and the evolution of the brain are all intimately correlated."[112] There is evidence that cooperative behavior activates two sections of the brain which produce chemicals engendering pleasurable sensations.[113] Reciprocal altruism is an adaptive behavior, formerly crucial to species survival and

109. WRIGHT, *supra* note 92, at 98-100. Development of writing, legal statutes and state-administration of judicial code in ancient Mesopotamia was response to "the problem of trust" among members of society "now that daily life involved . . . encounters with people who were neither relatives nor acquaintances." *Id.*

110. There is nothing inherently wrong with this, and it is not practical for a large franchisor to deal on a personal basis with hundreds or thousands of franchisees. But to maintain the Posner/IFA fictive kinship model flies in the face of commercial reality, and is hypocritical in light of post-contractual behavior of franchisors.

111. Owen D. Jones, *The Evolution of Irrationality*, 41 JURIMETRICS J. 289, 303 (2001). (noting "time-shifted rationality" as the "temporal mismatch of historically adaptive behavior and modern environments"). *See also* Owen D. Jones, *Time-Shifted Rationality and the Law of Law's Leverage: Behavioral Economics Meets Behavioral Biology*, 95 NW. U.L. REV. 1411 (2001). There is a certain irony in Judge Posner's son inadvertently making the sociobiologist's case. To the extent that a purchaser discounts the Offering Circular in favor of an intuitive judgment, there is another manifestation of evolutionary history. Moreover, "there is a growing consensus that the unconscious [has] cognitive capacities that rival and sometimes surpass that of conscious thought." Sharon Begley, *Follow Your Intuition: The Unconscious You May Be the Wiser Half*, WALL ST. J., Aug. 30, 2002, at B1.

112. Jones, *supra* note 111, at 304.

113. Natalie Angier, *Why We're So Nice: We're Wired to Cooperate*, N.Y. TIMES, July 23, 2002, at F1, F8 (M.R.I. scan of anteroventral striatum and orbitofrontal cortex showing dopamine production).

developed over millennia.[114] Trust itself may be based not on conscious thought but on neurobiology, most likely related to oxytocin production in the brain.[115]

In 2003, researchers at Emory University demonstrated that animals recognized a sense of fair play and would not cooperate with those who did not behave fairly; the scientists concluded that fair play appeared early in evolutionary history.[116] It is not possible to simply rationalize away such history, which is why concepts of fairness continue to influence judges and arbitrators. Such influence is central to the encroachment decisions favoring franchisees; notwithstanding an explicit reservation of the right to encroach, some jurists (and many non-lawyers) are offended by egregious unfairness of franchisors. [Cite]. Unfairness is a violation of reciprocal altruism and is a concept understood from childhood. The viability of reciprocal altruism as an adaptive behavior in franchising is problematic where the legal environment is tolerant of such practices as misstatements in pre-contractual dealings, encroachment, and price-gouging after the contract is signed and the investment made.

Cognizant of the negative image that the "Daddy/Son" analogy was presenting, industry lobbyists cited the adaptability of franchising and declared a "shift [that] moves the franchise relationship more in the direction of partnerships and away from the parental attitudes that were prevalent in the original business model."[117] Now franchisors tell prospective purchasers to "Buy a franchise, join a family!"[118] A

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114. F. de Waal & L.M. Luttrell, *Mechanisms of Social Reciprocity in Three Primate Species: Symmetrical Relationship Characteristics or Cognition?*, 9 ETHNOLOGY & SOCIOBIOLOGY 101-18, (1988) (finding that chimpanzees, the closest hominid species, engage in cooperative behavior). The pattern exists in other species and anthropological evidence is that it dates to the earliest humans. The topic is beyond the scope of this paper; an excellent bibliography may be found in GERD GIGERENZER, ADAPTIVE THINKING: RATIONALITY IN THE REAL WORLD (2000). *See also* WRIGHT, *supra* note 92, at 324 (reciprocal altruism provides adaptive advantage, and spreads beyond family to ever-widening social groups).

115. Ken Grimes, *To trust is human*, NEW SCIENTIST, May 10, 2003, at 32, 34-35. This is a developing branch of economics known as neuroeconomics. Oxytocin production occurs outside the large frontal cortex, implying that trust is a primitive and instinctive human reaction. *Id.* at 35, (*quoting* Paul Zak of Claremont Graduate University). Neuroeconomics contradicts classical theories such as the Nash equilibrium which posits that the level of trust should be zero. *Id.* at 33. (Nash was the mathematician whose life was chronicled in the movie *A Beautiful Mind.*).

116. James Randerson, *Primates reveal a sense of fair play*, NEW SCIENTIST, Sept. 20, 2003, at 19. Brain scans of humans suggest that unfairness is a primitive concept and may override higher-level brain functions. *Id.* (explaining why some angry franchisees may attempt to "bring down the house" when they perceive unfair treatment).

117. Don DeBolt, *Peace Prize: Franchisees, franchisors learn cooperation fuels prosperity of business*, NATION'S RESTAURANT NEWS, Dec. 23, 2002, at 26.

118. Valpak Direct Marketing Systems, Inc., *Buy a franchise, join a family!*

collective "Family" replaces the hierarchal "Parent":

"As one of our Franchisees, you'll feel like a valued member of a family . . . entrepreneurs who receive the personal attention, training, and support they need to succeed."[119]

B. Partnership

Franchising is presented to the prospective franchisee as a partnership, and franchisor sales ads tout their "Passion for Partnership"[120] and claim that "We're looking for A Few Good Partners .... Find out if you could be a ... Strategic Partner."[121] One franchisor website claims: "Franchising to Chem-Dry is all about being in a partnership."[122] A Buffalo wing franchisor says: "We're not just looking to add stores, we want to add partners."[123] It is not simply innocent franchisees who are deceived: Harvard Business School Professor Jeffrey Bradach claims that the "Contractual Relationship" in a company is that of an "Employee" while the "Contractual Relationship" of a franchise is "Partner."[124] Bradach adds: "different kinds of contracts support different types of relationships—company employees are subordinates of the chain operator, and franchisees are partners with the chain operator ... the chain operator-franchisee relationship [is] a partnership between owners."[125]

IFA's representative has testified before Congress about partnership and family, but franchisors exhibit behavior which would not live up to the standards of the most dysfunctional family. Judge Easterbrook observes that "[p]arties to a contract are not each other's fiduciaries; they are not bound to treat customers with the same consideration reserved for their families."[126] The problem with this analysis in the franchise context

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(Advertisement), in FRANCHISE TIMES, April 2003, at 29.

119. Great Earth Vitamin Stores, *We Are Family* (Advertisement), in ENTREPRENEUR, March 2001, at 120.

120. Country Kitchen, *A Passion For Partnership* (Advertisement), in NATION'S RESTAURANT NEWS, Sept. 16, 2002, at 101 (quoting franchisee Zach Trupos: "they treat you like a partner, not just a business associate.").

121. Max & Erma's, *We're Looking for A Few Good Partners*, (Advertisement), in FRANCHISE TIMES, April 2003, at 29.

122. Q & A on ChemDry by FRANCHISE WORLD MAGAZINE *available at* http://www.chemdry.co.uk/interview.html (last visited July 30, 2001).

123. Lori Lohmeyer, *Mo-Joe's spreads wings with franchise plans*, NATION'S RESTAURANT NEWS, Aug. 25, 2003, at 62.

124. JEFFREY L. BRADACH, FRANCHISE ORGANIZATIONS 32 (1998).

125. *Id.* at 33. The methodological flaws of Bradach's work stem from a naive view of the franchise relationship and how both sides maneuver to advance their interests. Bradach is not an accurate source, but is an (unintentionally) amusing one.

126. Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990).

is that there are gullible marks who believe they are joining, if not a family, at least a partnership. One franchisor attorney noted that she discouraged clients from speaking of the relationship as a "partnership" precisely because such a term as a matter of law does not reflect the franchisor-franchisee relationship.[127] The law imposes far more responsibility on Partners than mere parties to a contract.[128]

Partners have obligations both legal and moral, as Judge Cardozo famously noted:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[129]

A similar result has been reached in Australia. *Hungry Jack's*[130] (a Burger King case) contains a discussion of Australian law on partnership and fiduciary relationships where courts held that:

> If the joint venture takes the form of a partnership . . . the joint venturers will be under fiduciary duties to one another, including fiduciary duties in relation to property the subject of the joint venture, which are the ordinary incidents of the partnership relationship, though those fiduciary duties will be moulded to the character of the particular relationship (citation omitted).[131]

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127. Susan Grueneberg, Remarks at *Understanding Franchising: Business & Legal Issues*, Practising Law Institute (June 12, 2001). Two authors distinguished the relationship noting that, "[t]he business relationship must be one of a partnership (not a legal partnership) where franchisees have input on those matters that are of concern to them." *See* JUSTIS & VINCENT, *supra* note 6, at 323. But even as distinguished, partnership is more than simply having input. Franchisors deliberately misrepresent this to franchise prospects, and many prospects are foolish enough to believe them.

128. Uniform Partnership Act (UPA) § 21 (partner accountable as a fiduciary); Revised Uniform Partnership Act (RUPA) § 404 (partners owe duty of loyalty and duty of care); RUPA § 405 cmt. 1 (partners can sue partners for violation of a duty to the partnership). This analysis is particularly relevant in the area of encroachment: "A partner may not compete with the partnership without the permission of the other partners. [A] partner in . . . an automobile dealership cannot open a competing automobile dealership without . . . her partners' permission." HENRY R. CHEESEMAN, BUSINESS LAW 572 (3d ed. 1998).

129. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

130. Hungry Jack's Pty Ltd v. Burger King Corp, 1999 NSW LEXIS 61 (Sup. Ct. of New South Wales, Equity Division, Commercial List). In *Hungry Jack's*, the court found that Burger King owed a fiduciary duty to the regional master franchisee. *Id.*

131. *Id.* at *285-86 (*quoting* United Dominions Corp. Ltd. v. Brian Pty Ltd & Ors, 157 CLR 1, 10-11 (1985)).

Conversely, the Court cited the distributorship case of *Hospital Products* stated that "the fact that the arrangement between the parties was of a purely commercial kind, and that they had dealt at arm's length and on an equal footing, had consistently been regarded by the High Court as important, if not decisive, in indicating that no fiduciary duty arose."[132]

The recurrent themes of "partnership" and "family" are misleading and legally incorrect. Salesmen use kinship metaphors because they are effective.[133] Franchisees hear explicit representations of the partnership/family canard, and are induced to rely on those representations by franchise salespersons who know them to be false. Franchisors make "family" representations with impunity, since such statements are too vague to support a cause of action.[134] Franchisor salespeople are told: "Get them to make a decision on the spot. Talk to them like they're already owners. Trap them. Get them to say yeses. Work the angles!"[135] A former President of the IFA illustrates how "paternal" franchisors work the angles, as well as knowingly misstate the law, in a story about a sales meeting he attended. The former IFA President was in a meeting with his franchisor client and a prospective franchisee who was reluctant to sign the check to purchase a franchise. The franchisor spoke to the prospective franchisee "in an understanding, almost paternal, fashion" and "[y]et, the check still lay unsigned."[136] The former IFA President realized that he had to do something:

> It was then that I remembered something . . . explained to me many years ago at an IFA convention. I wondered aloud, "What about never closing the deal? Remember, you have to get the check every month?"
>
> [The franchisor] picked up on my comment. "That's right. With a franchise, you never really sell anything. You don't close the deal

132. *Hungry Jacks*, 1999 NSW LEXIS 61 at *273-274 (*quoting* Hospital Products Ltd. v. United States Surgical Corp., 156 CLR 41, 70 (1984)). A*ccord*, Ontario Ltd. v. Bulk Barn Foods Ltd., 2000 Ont. Sup. C.J. LEXIS 1945, at *8 (Ontario Super. Ct. of Justice, Divisional Court, 2000) (Courts should be slow to impose fiduciary duties where "relationship is between commercial entities governed by the terms of a contract," *quoting* Scott v. Trophy Foods Inc., 123 D.L.R. (4th) 509, 528 (Nova Scotia Ct. of App., 1995).

133. *See* PINKER, *supra* note 25, at 247 (citing G.R. JOHNSON, S.H. RATWICK & T.J. SAWYER, *The evocative significance of kin terms in patriotic speech*, in THE SOCIOBIOLOGY OF ETHNOCENTRISM (V. Reynolds, V. Falger & I. Vine, eds., 1987).

134. Carlock v. Pillsbury Co., 719 F. Supp. 791, 837 (D. Minn. 1989).

135. Behar, *supra* note 46, at 130 (quoting Subway sales director Don Fertman). Subway has since changed its sales approach and now encourages prospects to carefully consider their decision before making a franchise purchase.

136. Jerry Wilkerson, *True Confessions of a Franchise Sales Executive*, FRANCHISE RECRUITERS LTD. NEWSL. 2001, at 1,2.

> with this check," [the franchisor] stated, pointing to the [franchisee's still-unsigned check]. "You simply start the relationship process. Every month we have to get the check, earn the check, give you a reason to send the check for your royalty payment. It is our responsibility to keep you in business, profitable . . . this is what you're buying into, why you send us the monthly check . . . ."[137]

As a matter of law, the former IFA President is wrong, as the franchisee will quickly discover should the franchisee ever decide—for any reason—to stop sending the monthly check (in fact, the large franchisors take royalties directly from the franchisee's bank account).[138] If the franchisor fails "to get the check every month," the franchisor will promptly file suit at the courthouse down the road from franchisor headquarters; the franchisee will have to travel whatever distance is necessary to defend the action. The franchisee's recitation of the above-mentioned conversation will not sway the judge, and franchisors deprived of royalties are not noted for being understanding, let alone paternal. If the franchisee dares to challenge the authority of the "paternal" franchisor, the franchisee will be disowned (terminated) by the "parent" and the franchise re-sold to another victim. If the franchisee fails to remit the check one month in reliance on the former IFA President's statement, the franchisor would simply point to the contractual obligation to remit the monthly check, and exclude the former IFA President's statement by pointing to the integration clause.

If the franchisee stops paying royalties the franchise will be terminated.[139] The franchisee will be forced to pay the withheld royalties and may even be sued for royalties which would have been due if the franchise agreement had run its term; one franchise attorney refers to this as "the pot of gold a franchisor may see at the end of the rainbow when it terminates a franchise agreement."[140] In *TCBY Systems, Inc. v. RSP Co.*,

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137. *Id.*

138. *See, e.g.*, Behar, *supra* note 46, at 132 (discussing franchisee threats to withhold royalty monies, noting franchisor directly debits franchisee bank accounts).

139. Contrary to the former IFA President's assertion, not only do franchisors *not* have to "earn" the royalty check, the franchisor can actively mismanage the brand and push franchisees to bankruptcy without forfeiting the check. *See* Amy Zuber, *Burger King Gets $70M From Diageo, But Company, Franchisees Still Struggle*, NATION'S RESTAURANT NEWS, July 23, 2001, at 1 (franchisee attorney Robert Zarco claims inept franchisor damaged brand and then terminated franchisees unable to pay royalties due to resultant sales decline).

140. Rupert M. Barkoff, *Damage Awards: 'Burger King v. Hinton'—A 'PIP' of a Decision*, N.Y.L.J., Nov. 20, 2002 at 3, 15. (noting modification of historical contract law principle that franchisor could recover present value of future revenue stream lost due to franchisee cessation of operations). *See also* Dennis R. LaFiura & David S. Sager, *Liquidated Damages Provisions and the Case For Routine Enforcement*, 20 FRANCHISE L.J. 175, 177 (2001).

Inc.,[141] a frozen yogurt franchisee chose a location in central Minnesota. The franchisor, which boasted of its expertise in site selection, approved the site despite the fact that it did not meet the franchisor's own criteria in multiple respects.[142] It refused to approve the franchisee's request to add "cold weather" items, no small matter for a frozen yogurt store in Minnesota, and the franchise failed, whereupon the franchisor attempted to sue for lost royalties for both the contract term *and* the renewal period.[143] Even where the franchisee is working for little or no money, he must continue to work—and pay royalties to the franchisor—or risk a judicial order, requiring payment of "lost" royalties and advertising fees for the entire term of the agreement. In refusing to grant one franchisor's demands, a California court noted:

> [don't] do everything . . . the franchisor demands and the franchisee risks declaration of a "material breach" backed up by the whip of a giant "lost future profits" award. Such an award would leave the franchisee enslaved for 5 or 10 or 20 years.[144]

If the franchise agreement contains a liquidated damages clause, the franchisor can recover "lost profits," not suffer any deduction for expenses not incurred, and then open up a new franchise in the area. If the franchisee does not have an exclusive territory, the franchisor may encroach at will, put the franchisee into a cash squeeze, and then claim breach when the franchisee is unable to pay royalties. Termination notices provide little or no time for a franchisee to sell his interest.[145] A terminated franchisee will loose his entire investment, be sued for past due and future royalties, and have to find a job not prohibited by the noncompete clause, continuing to toil for the franchisor long after the franchisor has located a new crop of franchisees. A savvy franchisor such as Allied Domecq (Dunkin Donuts, Baskin Robbins, Togo's) will show a franchisee a copy of the Encroachment Impact Policy to induce the franchisee to waive legal rights by assuring the prospect that the franchisor will not encroach on the franchisee. After the franchisee complies with franchisor demands, the franchisor will site stores in violation of its own Encroachment Policy (after directing the "independent" analyst to rework numbers to show no impact) and then hide behind the integration clause of the franchise agreement to saturate

141. 33 F.3d 925 (8th Cir. 1994).

142. *Id.* at 927.

143. *Id.* at 927-28. The Arkansas jury found for the franchisee and awarded $70,000 in damages. *Id.*

144. Postal Instant Press, Inc. v. Sealy, 51 Cal. Rptr. 2d 365, 375 (Ct. App. 1996).

145. Dunkin' Donuts Inc. v. Taseski, 47 F. Supp. 2d 867, 875 (E.D. Mich. 1999) (citing Dunkin' Donuts of Am., Inc. v. Middletown Donut Corp., 495 A.2d 66, 72 (N.J. 1985); KFC Corp., v. Goldey, 714 F. Supp. 264, 266 (W.D. Ky. 1989)).

the market, thereby driving the franchisee out of business and into such penury that the franchisee cannot afford to pay an attorney.[146] Not only will the court rule that the franchisor is not a partner, the court will express doubt that the franchisor is bound by the word of the franchisor salesman.[147]

Allied Domecq is one of the most litigious franchisors. One news report referred to the "Dunkin' lawsuit barrage . . . an extraordinary wave of at least 350 lawsuits initiated by [Dunkin'] against its franchisees . . . by comparison, McDonald's Corp. reportedly had sued only about a dozen of its franchisees over the same period."[148] But Allied Domecq's methods have been successful in court. Allied Domecq, lawsuit barrage notwithstanding, remains a member in good standing of the IFA, with the IFA opposing giving franchisees a private right of action on the grounds that "court should be the last place to resolve disputes."[149] What the franchise industry has been slow to recognize is that franchisor litigation is frequently counterproductive. Dunkin's devotion to litigation takes away time better spent addressing the competitive pressures of invasions by Krispy Kreme from North Carolina and Tim Horton from Canada. One franchisor lawyer noted that during the "Golden Age of Subway Arbitration Cases" some franchisees "would certainly rather fight than make sandwiches."[150] Ultimately, Subway's parent company initiated a number of changes designed to introduce more transparency, more franchisee input, and less adversarial methods of dispute resolution; the chain subsequently experienced record growth.[151] Allied Domecq, which has followed the Subway pattern in some respects, recently brought in a new CEO who has indicated a desire to have a less litigious relationship with franchisees.[152] But franchisees should not be forced to rely on

146. Harford Donuts, Inc. v. Dunkin Donuts, Inc., No. CIV. L-98-3668, 2001 WL 403473, at *3-6 (D. Md. 2001).

147. *Id.* at *5 n.13.

148. Richard Martin, *Franchisee Sentenced Amid Dunkin' Lawsuit Barrage*, NATION'S RESTAURANT NEWS, Apr. 28, 2003 at 4.

149. Don J. DeBolt, *If it Ain't Broke: Gov't Needs to Stop 'Fixing' Franchising, Leave Existing Laws Alone*, NATION'S RESTAURANT NEWS, June 26, 2000, at 56.

150. Arthur Pressman, *Arbitration under attack—Has the pendulum swung?*, FRANCHISE TIMES, May 2003, at 45. For a list of the Subway cases, *see* Dunham, *supra* note 90, at 93, n.22.

151. Lori Doss, *Sub standard no longer: Subway rolls unit design upgrade: New look aimed at turning nation's biggest into stylish, fast-casual player*, NATION'S RESTAURANT NEWS, March 11, 2002 at 8 (noting that the recent growth rate was 7 times higher than competitors, and that due to the "long history of skating on thin ice with franchisees" Subway's creative director sought out franchisee input for store remodeling plan).

152. Lohmeyer, *supra* note 46, at 85 (positive franchisee comments on new CEO Jon Luther). Steve Horn remains general counsel, and Luther denies that the litigation and restructuring are related. *See* Jon Luther *Allied Domecq CEO: lawsuits not related to restructuring*, NATION'S RESTAURANT NEWS, Sept. 15, 2003, at 27.

franchisor decisions (whether motivated by conscience or economics) to refrain from abusive relationship practices.

Franchisors are aware of the combined effect of the lack of regulatory vigor coupled with franchisors' vigorous enforcement of the merger and integration clause. Although the integration clause is not dispositive of a claim for fraud in the inducement,[153] it does provide a significant shield which courts are reluctant to penetrate.[154] Courts refuse to permit evidence of prior negotiations even after conceding that contracts cannot be "isolated from the objective matrix of facts in which they were set."[155] So franchisors are free to represent the franchise relationship as a "partnership" in which the franchisee is "given a reason" to send a royalty check to the "paternal" franchisor which must constantly strive to "earn" that check.

Franchisors have long infantilized their franchisees; Hadfield's examples from the 1970's are mirrored by franchisors today. As illustrated by the story of the former IFA President, the process begins with paternalism, and then proceeds to inducing the franchisee to enter into a contract of adhesion in which the franchisee is committed to ongoing royalty payments. In addition to royalty payments, the franchisee often surrenders control of his or her future. Lease rights are the property of the franchisor, customer lists are the property of the franchisor, and telephone numbers[156] are the property of the franchisor. The logo sign on the door, paid for by the franchisee, may only be displayed with permission of the franchisor. Equipment used in the franchise operation, emblazoned with the franchisor logo, may only be displayed with the permission of the franchisor. The very ability of the

153. Layton v. AAMCO Transmissions, Inc., 717 F. Supp. 368, 371 (D. Md. 1989) (citing Call Carl, Inc. v. BP Oil Corp., 554 F.2d 623, 630 (4th Cir. 1977)).

154. Many jurisdictions follow a variant of the "New York Rule": Fraudulent inducement claim barred by parol evidence rule where claim alleges: (1) Oral promise not "collateral or extraneous" to contract, or (2) promise as to "future expectations", or (3) oral promise within Statute of Frauds, Thomas J. Dougherty & Wystan M. Ackerman, *When Fraud Claims are Barred By the Parol Evidence Rule Under New York Law*, N.Y. BUS. L.J., Fall 2002, at 43.

155. Prenn v. Simmonds, [1971] 3 All E.R. 237, 239 (Lord Wilberforce).

156. On economic value of phone numbers, esp. toll-free alphanumeric, *see* In re Dial-A-Matress Operating Corp., 240 F.3d 1341 (Fed. Cir. 2001); Dial-A-Mattress Franchise Corp. v. Page, 880 F.2d 675 (2d Cir. 1989) (finding phone number 800-MATTRES entitled to trademark protection); Zockoll Group Ltd. v. Telecom Eireann, 1995/9781 P (Transcript), (High Ct., Nov. 28, 1997) (discussing introduction of alphanumeric in Ireland, noting that in the U.S. "Hopeless romantics may avail themselves of the services of a florist by dialing 1-800 FLOWERS" and use of 800 #s in franchising in U.S. and Ireland); *see also* In re Security Investment Properties, Inc., 559 F.2d 1321, 1324 (5th Cir. 1977) ("numbers constitute a unique property interest"); In re Fountainbleau Hotel Corp., 508 F.2d 1056, 1059 (5th Cir. 1975) ("telephone numbers are a valuable asset").

franchisee to earn a living in the franchisee's chosen vocation depends on the good graces of the franchisor by way of a non-compete clause, which survives even if the franchisee does not. Even the spouse of the franchisee may be controlled by the franchisor via spousal guarantees and covenants.[157]

Infantilization of franchisees serves several purposes in both pre and post-sale periods. Pre-sale, the most common use is to persuade the prospective franchisee to let down her guard; to trust the verbal representations of "Father Franchisor" in the face of an integration clause, which belies the illusory familial bliss of the franchisor's sales pitch.[158] Post-sale, infantilization is useful both as a "Father Knows Best" defense to an arbitrator (or legislator) determined to rein in abuse of franchisor discretion, and to reconcile the moral cognitive dissonance caused by franchisor abuse. Artfully drafted franchise contracts may provide an impregnable legal fortress, but the "because the contract says I can" argument does not address the human need to feel that one is a morally worthy person.

Parent-child relationships can take a counterintuitive cast where the parent with the power believes all acts are justified: suttee has been accepted practice in cultures where parents believed the practice to be morally righteous.[159] Driving a franchisee into financial ruin is not on a par with suttee (although an Australian legislator said it had driven franchisees to suicide),[160] but abusive practices will cause pangs of conscience among at least a few members of the franchisor's staff. As a business matter, moreover, a parent has a finite number of children while a franchisor can replace franchisees, albeit at a potentially higher discount rate. In a large, mobile society the ease with which franchisees can be replaced greatly reduces any penalties for franchisor overreaching.[161] Franchisees resisting franchisor opportunism and abuse are often told to sell their franchise or be terminated and/or encroached: as one McDonald's franchisee was told by McDonald's, "one of us has

157. Patrick L. Abramowich, *Spousal guaranty Q&A for franchisors*, FRANCHISE TIMES, Apr. 2002, at 39 ("Courts routinely enforce spousal guarantees").

158. A rare example of a franchisor cognizant of this is the Midas executive who said "life isn't about contracts, it's about trust." Brandon Copple, *Life Is About Trust: when you are in the franchising business, a little love and tenderness goes a long way. Just ask those muffler shop owners,* FORBES, Jan 11, 1999 *available at* 1999 WL 2046117 (quoting Midas CEO Wendell Province).

159. LUTHERAN CYCLOPEDIA 1020 (Erwin Lueker, ed.) (1954).

160. Philip F. Zeidman, *Shattering the myths*, FRANCHISE TIMES, Apr. 2002, at 27 (regarding Hannaford Seedmaster Services franchisor).

161. *Cf.* LOUISE BARRETT, ROBIN DUNBAR, & JOHN LYCETT, HUMAN EVOLUTIONARY PSYCHOLOGY 254 (2002) ("Freeriders can stay one step ahead of discovery in large populations because there are always new naïve individuals to exploit.").

to go and it sure isn't going to be us."[162]

C. *Franchise Success/Failure Rates*

Franchising is ubiquitous in America and covers everything from dating services[163] to caskets[164] to yoga[165] to cattle semen.[166] McDonald's paid to be included in the top-selling *Sim City* which allows players to become "virtual franchisees,"[167] and the latest fad is parents buying their children "The Ultimate Graduation Gift: Your Very Own Franchise."[168] In the 1984 comedy *Ghostbusters*, one of the characters takes out a mortgage to get money to establish a business chasing ghosts. He is reassured of success by the Bill Murray character, who tells the nervous borrower: "The franchise rights alone will make us rich beyond our wildest dreams."[169] By 2001, one of the franchisors at the International Franchise Expo was the Aura Shop, "which allows franchisees to scan their customers' aura and then sell them products that can balance and energize the body and soul."[170] By 2003 Space Aliens Bar & Grill was

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162. Far Horizons Pty Ltd. v. McDonald's Australia Ltd. (2000) V.S.C. 310; BC200004860.

163. *Singles start setting dates with destiny*, FRANCHISE TIMES, Jan. 2002, at 11.

164. Mike Hendricks, *Getting a discount on death*, KANSAS CITY STAR, Apr. 18, 2001, at B1.

165. Vanessa Grigoriadis, *Controlled Breathing In the Extreme*, N.Y. TIMES, July 6, 2003, at 9 (California yoga instructor took 26 of yoga's 84 positions, copyrighted the program, and is now seeking to franchise the 2600 year-old discipline. The yogi has threatened legal action against competitors, so apparently even yoga is not immune to the adversarial nature of franchising.).

166. Dan Morse, *Fast-Food Franchise Securitized Loans Lose Their Sizzle*, WALL ST. J., July 11, 2000, at B2 (describing cattle rancher planning to franchise ranching).

167. Matt Richtel, *Product Placements Go Interactive in Video Games*, N.Y. TIMES, Sept. 17, 2002, at C1. McDonald's paid Electronic Arts for placement in the popular Sims Online game. *Id.* Since McDonald's paid for placement, it is unlikely that the "franchisee" will suffer virtual encroachment or virtual termination. *Id.*

168. Jacob Bunge, *The Ultimate Graduation Gift: Your Very Own Franchise*, FRANCHISE TIMES, Sept. 2002, at 16. The converse is children buying franchises for parents: when Sharon Stone wanted to buy her mother an Auntie Anne's pretzel franchise, she became angered when told that the franchisee, not the relative of the franchisee, must personally buy the franchise. Stone angrily asked founder Anne Beiler "do you know who I am?" Beiler, a conservative Mennonite, had never heard of the actress and told Sharon Stone "no, I've never heard of you." *See* Julie Bennett, *Don't try this Alone: Amazing Acts of Daring and Denseness by Franchisees*, FRANCHISE TIMES, Aug. 2003, at 10, 42. Actor Jason Priestley (*Beverly Hills 90210*) and Chicago Bears punter Brad Maynard were more successful in their efforts at becoming franchisees, buying Roly Poly sandwich outlets. *See Roly Poly Signs Celebs to Pact for Indianapolis*, NATION'S RESTAURANT NEWS, June 24, 2002 at 164. Akinola Olajuwon (brother of basketball star Hakeem Olajuwon) was less successful, filing for Chapter 11 when his Denny's restaurant holdings failed. *See* Dan Morse, *supra* note 166.

169. GHOSTBUSTERS (Columbia Pictures 1984).

170. *IFE provides one-stop shopping for serious franchisees*, FRANCHISE TIMES, Aug. 2001, at 9.

pitching franchises.[171]

A survey found that 70% of Americans felt they knew enough about franchising to explain it to others.[172] This attitude has enabled the franchise industry to sell to unsophisticated purchasers, and led to a perception which feeds into franchisor sales pitches presenting franchising as a surefire road to entrepreneurial success. The president of the International Franchise Association urges "those who received pink slips" to buy a franchise:

> [T]he odds of succeeding are favorable for two reasons. First, franchises allow individuals to take charge of their careers, their financial destinies, and their lives . . . putting money into a franchised small business offers more control over the return than a passive investment in a volatile stock market can offer .... [Second], consumer confidence [in franchised brands] makes a franchise business a good investment and one that will be more stable than an independent business in a sluggish economy.[173]

Anyone who has ever been subject to the strictures of a franchisor might dispute the notion that a franchisee controls her own destiny. Consumer confidence in a brand makes for a wealthy franchisor; as many a franchisee knows, that does not necessarily make for a wealthy franchisee. The more successful the franchised brand, the less likely it is that the consumer purchasing a franchise will question the outlet's profitability. While the New York Attorney General may speak of franchise ownership as the "American Dream," Subway founder Fred DeLuca, a billionaire who has fought his franchisees all the way to the U.S. Supreme Court, told a reporter that when his franchisees lose money "I don't lose sleep over it[,] [t]his is America."[174]

Franchises sell based on perception of success, not reality.[175] A prospect sees a franchise that has been in business for a few years and does not realize that it has had multiple owners and the current owner is there only because he has no option other than going bankrupt or selling out at a major loss (which may ultimately result in bankruptcy). A former franchise salesman noted: "[i]t becomes like the battered-wife

171. Nancy Weingartner, *Mothership seeks Space Aliens*, FRANCHISE TIMES, Sept. 2003, at 11.

172. Michael E. Cobo, *How Potential Jurors View Franchising*, 21 FRANCHISE L.J. 182 (2002) (analyzing nationwide sample of persons qualified to serve as jurors).

173. Don DeBolt, *Layoffs, slower economy focus attention on franchised businesses as career alternative*, NATION'S RESTAURANT NEWS, Jan. 14, 2002, at 23.

174. Behar, *supra* note 46, at 128.

175. *See* Judith Evans, *Take a Good Look Before You Leap*, WASHINGTON POST, June 27, 1999, at HO8 (noting that people buy after seeing fastest-growing rankings in popular magazines).

syndrome, where tomorrow will be a better day. And people refuse to leave and accept the failure."[176]

The interplay between perception and behavior is complex, and the motivating force of illusions may overcome the encyclopedic offering circular.[177] The very form of the offering circular results in prospective purchasers' resort to heuristics biased towards underestimation of franchisor overreaching.[178] Misperceptions as to the true nature of the franchise relationship are enough to create an overconfidence bias. Such bias is almost assured when prospective franchisees believe the Federal Trade Commission has vetted and is a watchdog over the franchisors.

Recent statements by the New York Attorney General's Office praising franchising as "a fabulous opportunity for those people"[179] are just the most recent of a series going back at least 15 years[180] which are quoted by franchisor supporters in "How To" books targeted at prospective franchisees:

> Government research indicates that the success rate for franchise-owned endeavors is significantly better than the rate for non-franchised owned small businesses. These same findings also show that 80% of all new small businesses fail, many within the first year. By contrast less than 2% of new franchises are discontinued over a three-year period.[181]

A British visitor to the FranInfo website is told that "91% of franchisees report profitability .... Past experience is generally not a pre-requisite [to buying a franchise]."[182] In a "Dear Prospective Franchisee" letter, the franchisor of Beverly Hills Weight Loss & Wellness Centers (headquartered in New Hampshire) lists "success rates of franchised

176. Behar, *supra* note 46, at 132 (quoting Steve Sager, a former New Jersey-based agent for Subway).

177. *Cf*, STANLEY H. TEITELBAUM, ILLUSION AND DISILLUSIONMENT: CORE ISSUES IN PSYCHOTHERAPY 129 (1999); ANTHONY ROBBINS, UNLIMITED POWER 35-52 (Fireside ed. 1997) (1986) (stating that the perception of objective reality is the result of the mental state of the observer, which in turn alters the objective reality.).

178. For example, brand familiarity, system size, FTC "disclaimer" notice and formal language style in UFOC. Heuristics are the techniques used when confronted with the need to make a decision based on complex data and avoid "cognitive gridlock." *See* SIMPLE HEURISTICS THAT MAKE US SMART (Gerd Gigerenzer et. al. eds., 1999).

179. See Kaufmann, *supra* note 22.

180. Robert L. Purvin, *Franchising: Yesterday, Today, and Tomorrow*, in FRANCHISING 101: THE COMPLETE GUIDE TO EVALUATING, BUYING, AND GROWING YOUR FRANCHISE BUSINESS 3 (Ann Dugan, ed., 1998) (citing Int'l Franchise Assn., FRANCHISING IN THE ECONOMY 1991; Dept. of Commerce, FRANCHISING IN THE ECONOMY 1984-1986).

181. Erwin J. Keup, FRANCHISE BIBLE: HOW TO BUY A FRANCHISE OR FRANCHISE YOUR OWN BUSINESS 6 (4th ed., 2000).

182. Franchising in the UK, *available at* http://www.franinfo.co.uk/franchisinginuk.lasso (last visited June 19, 2004).

businesses" at "95.6% in the first year alone" without providing any documentation for the claim.[183] In India, despite franchisor scandals including complaints against the NIIT[184] and Skumars.com[185] chains, criminal charges against a Mumbai (Bombay) franchisor,[186] and the arrest of a New Delhi franchisor,[187] prospects are being told that "Franchising enjoys an 85 percent success rate in India."[188]

Despite the fact that cellular phones did not even exist in 1971, an American cellular franchisor founded in 1994 distributed a promotional brochure in 2000 containing a bright red box with the statement: "Since 1971, less than 5% of all franchises have failed or were discontinued each year. By contrast . . . 65% of independent business start-ups fail within the first five years, U.S. Department of Commerce."[189] The statement is in quotes, so a prospective franchisee would assume that the U.S. Government had made a recent statement supporting the superiority of franchising based on 29 years of data. Below the claim, the franchisor displays a prominent IFA logo and says "we are registered and listed" with the Small Business Administration Franchise Registry "which provides stream lined review and processing" for financing. In the Blenheim Expositions case, it was the IFA itself in 1992 which released the results of a Gallup poll used by Blenheim in promoting the International Franchise Expo:

> If you buy a Franchise Business, your chances of success are 94%! THAT'S A FACT, according to a recent Gallup poll. Conversely, it's estimated that only 35% of independent business start-ups survive 5 years.[190]

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183. Letter from the franchisor of Beverly Hills Weight Loss & Wellness Centers to the author (Feb. 27, 2001) (on file with author).

184. *NIIT's Franchisees Facing Shutdown*, TIMES OF INDIA, Aug. 27, 2002, *available at* 2002 WL 25386166. The franchisor of education centers kept 47% of net receipts, and the head of the franchisees' association also attributed difficulties to franchisor mismanagement. *Id.*

185. Saikat Chatterjee, *Skumars.com Shelves VSAT Plan, to Focus on Fibre*, TIMES OF INDIA, Jan. 16, 2002, *available at* 2002 WL 2265452. The franchisees were promised refunds, but did not receive them, 1400 franchisees were affected. *Id.*

186. Makarand Gadgil, *Franchisees Sue Bombay Bazaar*, TIMES OF INDIA, Nov. 1, 2002, *available at* 2002 WL 102341904 (noting that franchisees were issued refunds, but the checks bounced).

187. *Zap Official gets Bail, Police Asked to File Reply by July 26*, TIMES OF INDIA, June. 16, 2001, *available at* 2001 WL 21136196.

188. Leading Edge/Deepanjali Bhas., *Primary Healthcare is a Cottage Industr*, TIMES OF INDIA, Apr. 22, 2002, *available at* 2002 WL 19676657.

189. Brochure from, @WIRELESS, FRANCHISE OPPORTUNITIES: A COMPLETE TURN-KEY RETAIL SOLUTION IN ONE OF TODAY'S HOTTEST MARKETS! (brochure on file with author, undated, received May 2000).

190. Press Release, Federal Trade Commission, Franchise Show Promoter Agrees to Settle FTC Charges of Misrepresenting Earnings and Success Rates of Franchises (Sept.

The FTC found the statement to be false, and charged that even with a skewed sample "the actual results of the Gallup poll do not support the claims."[191] The FTC Director of Consumer Protection noted: "Misinformation about the likelihood of success as a franchisee is of particular concern given the sizable investments that are often required to purchase a franchise."[192] An FTC Commissioner told a gathering of franchise attorneys that "it truly is in everyone's best interest not to tout overly optimistic success claims."[193]

The imprimatur of the state Attorney General or the federal government[194] is particularly effective for unsophisticated purchasers who are led to believe that franchising offers (depending on the "data" cited) represent a 94% or 98% success rate after three years while being told that starting their own business is a doomed endeavor. However, as outlined in a Congressional staff memorandum, empirical data does not support franchise industry claims.[195] A 1993 study by the American Association of Franchisees and Dealers showed that only 31% of franchisors themselves were still in business after five years.[196] If the majority of franchisors are unable to stay in business, it is difficult to see how franchisees can have a 98% success rate. Note that many franchises are restaurant franchises,[197] and a study of restaurants in Columbus, Ohio revealed that the failure rates were 37% for chains and 38% for independents.[198] Given the inability of many franchisors to stay in business, it is no wonder that one of the largest franchisor-side law firms opposes requiring disclosure to prospective franchisees of bankruptcy

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27, 1995) *available at* http://www.ftc.gov/opa/1995/9509/bexpo.htm.

191. *Id.*

192. *Id.*

193. Commissioner Christine A. Varney, FTC Franchise Review, Address before the ABA 1995 Forum on Franchising (Oct. 13, 1995), *available at* http://www.ftc.gov/speeches/varney/casdocx.htm (last visited June 19, 2004).

194. Even after success rates have been debunked, the government still announces that there are opportunities in Arab nations because they "have recognized that in most instances franchise operations are relatively safe and profitable." Export America GLOBAL NEWS LINE *at* www.trade.gov/exportamerica/Volume%202/ea_dec_html/gnl_1201.html (last visited June 19, 2004) (discussing the UAE).

195. Staff Memorandum to John J. LaFalce on Franchise Industry Research & Data including Franchise Success/Failure Rates (Jan. 1994), *reprinted in* ROBERT L. PURVIN JR., THE FRANCHISE FRAUD 236-253 (1994).

196. Purvin, *supra* note 180, at 4.

197. Amy Spector, *IFA Confab Weighs Legal Complexity of Online Franchise Marketing*, NATION'S RESTAURANT NEWS, Mar. 12, 2001, at 4, 98 (Frandata analysis of IFA membership showed 18% Quick Service Restaurant and 9% casual dining).

198. *Cities that Sizzle: Columbus, Ohio*, NATION'S RESTAURANT NEWS, Jan. 2001 at 46, 48. (Study by OSU hospitality professors). However, the nationwide picture showed the pressure of chains on the independents, though not distinguishing between franchised and company chain outlets. *Id.*

information on a franchisor's predecessors and affiliates.[199]

What franchisee prospects will not hear from regulators is that academic studies such as those conducted by Scott Shane at the Massachusetts Institute of Technology[200] and Dr. Timothy Bates of Wayne State University paint a different picture. Bates testified before Congress that notwithstanding higher capitalization of franchisees, they failed at a *higher* rate than independent businesses; after four years 61.3% of franchisees were still in operation versus 73.1% of independent start-ups.[201] Franchisor data at best under-report failure since franchisors define failure from the franchisor's perspective. For example, franchisors will say that an outlet is a success because it has been in business for three years without accounting for the fact that it has changed hands four times and none of the franchisees was able to eke out more than a subsistence living at best. Or the franchisor will consider the outlet a success even though the franchisee is saving money by not paying workers statutory wages, overtime, and social security payments.[202] Or the franchisee's family is working for negligible pay in order to keep the business afloat. There is also a distinction between large and small franchisees: a small Burger King operator may be permitted to go under while the franchisor attempts to keep larger operators from the same fate.[203]

To speak of franchising as a fabulous opportunity is meaningless since "franchising is a method of commercial cloning, and it is as easy to

199. E-Mail from John W. Fitzgerald, Gray Plant Mooty Mooty & Bennett P.A., to the Federal Trade Commn. (Jan. 31, 2000), *available at* http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment040.htm (opposing proposed § 436.5(l)). The e-mail notes that the author's law firm represents more than 50 franchisors. *Id.* The firm also lobbys on behalf of franchisors. *See* Kristine McKenzie, *Legislation Opponents Gather for Town Meeting*, FRANCHISE TIMES, Sept. 2000 at 6 (noting that the law firm arranged a franchisor meeting with Congressman Ramstad (R-MN)).

200. Purvin, *supra* note 180 at 4 (citing Scott A. Shane, HYBRID ORGANIZATIONAL ARRANGEMENTS AND THEIR IMPLICATIONS FOR FIRM GROWTH AND SURVIVAL: A STUDY OF NEW FRANCHISORS (1995)). For a discussion of Shane's subsequent study, *see* Janet Sparks, *Franchise Consultant of a New Breed Conducts Scientific Survey: Non-exclusivity May be Hazardous to Franchisor's Health*, FRANCHISE TIMES, June/July 2003, at 51.

201. *Franchising Relationship, supra* note 49, at 88 (statement of Timothy Bates, College of Urban, Labor & Metropolitan Affairs, Wayne State Univ.).

202. For a multi-unit franchisee, this can amount to a large amount. *See Waffle House Franchisee Hit with $2.9M OT Ruling*, NATION'S RESTAURANT NEWS, Sept. 3, 2001, at 3. At 100-unit franchisee Treetop Enterprises, managers claimed they worked 80-100 hours per week. Cowan v. Treetop Enters., Inc., 163 F. Supp. 2d 930 (M.D. Tenn. 2001).

203. *Diageo PLC Said to Weigh $2.2B BK Buyout Offer; Chain to Broker Operator Bailouts*, NATION'S RESTAURANT NEWS, Jan. 7, 2002, at 1, 74. The Taco Bell franchisor took accounting charges of $26M to assist 1,000 financially weak U.S. outlets. *See* Richard L. Papiernik, *Tricon Outlines Strategies to Boost U.S. Sales, Grow Abroad*, NATION'S RESTAURANT NEWS, Apr. 9, 2001, at 4, 87.

clone a poor concept as a successful one, perhaps even easier."[204] Just as there is a difference between a speculative penny stock and a solid blue-chip, so too there is a difference between franchisors. Franchising is seen as a lifeline by companies with poor management and poor business plans. In 2001, Wall Street Deli announced that they might go out of business; part of their rescue plan was to franchise company stores or close them if no franchisees would buy.[205] A recent example of this phenomenon is the Cosi sandwich chain. By the time of its initial public offering (IPO), the chain had already accumulated losses of $1.4 million per store,[206] a substantial amount for locations which sell primarily sandwiches and coffee. Ten weeks after raising $38.9 million in the IPO, the company blamed bad weather and tightwad consumers for ongoing losses.[207] According to industry analysts, however, Cosi's "problems are more fundamental" than operations, Cosi had a "grand plan . . . [that] failed to gel."[208] But Cosi's chief executive Jay Wainwright found a solution, he decided to craft a franchising plan.[209] No doubt Cosi will trumpet its 97 locations, snazzy décor, and prime locations, and franchisees will be seduced by a poor concept which has accumulated net losses of $114 million,[210] and is now seeking franchisees to bail out bad management.

Success rates are also presented in a manner designed to mislead prospective franchisees. Recent studies have shown that panels of law students and judges make different decisions based on statistical data presented in terms of probability rather than frequency.[211] The results suggest that a franchisee presented with the claim that "franchises have a 2% failure rate" is more likely to dismiss the prospect of failure than one presented with the claim that "3,000 franchisees failed out of 150,000."

Franchisors further seek to confuse prospects by not discussing failure rates directly, but rather by using sales brokers to make claims. For example, the Franchise.com website tells prospects that "[a]ccording to the Small Business Administration, less than 5% of all franchise units fail each year. This is compared to 30% to 35% of small businesses

204. Purvin, *supra* note 180, at 4.

205. *Wall Street Deli Expects Loss, Eyes 'Strategic Alternatives,'* NATION'S RESTAURANT NEWS, July 2, 2001, at 12.

206. Louise Kramer, *Overambitious Cosi Eats Its Words*, CRAIN'S N.Y. BUSINESS, March 3-9, 2003 at 1, 32.

207. *Id.* at 32.

208. *Id.*

209. *Id.*

210. *Id.*

211. Samuel Lindsey, Ralph Hertwig, & Gerd Gigerenzer, *Communicating Statistical DNA Evidence*, 43 JURIMETRICS J. 147, 157 (2003). The study was conducted in Berlin, but the paper cites U.S. studies. *See id.* at 153 n.34.

which fail within the first year of operation."[212] Recall that the Franchise Bible claims government statistics of less than *2%* franchise failure rate over *3 years*, the @Wireless franchisor claims less than *5%* franchise failure *per year*, and a 65% independent business failure rate over 5 years. Franchisors use un-cited "government statistics" to prove whatever they think will close the sale. On a recent visit to the website, adjacent to the Franchise.com claim were the logos of various franchisors including one for an Internet company promising that the prospective franchisee can be "In Business in Minutes."[213] The Franchise.com broker also provides six reasons franchisees fail, all of which relate to franchisee shortcomings such as lack of hard work or undercapitalization; nowhere does the broker even suggest the possibility of franchisor mismanagement.[214]

D. Earnings Claims

Understanding the difficulty with earnings claims also leads to a better understanding of the imbalance in franchise law. Few people would start a job without knowing what the salary was or what their prospects for advancement at the company were. Few would invest in a stock without some idea of the prospective earnings of the company and the likelihood that the company was sound and would remain in business. Few would invest in a franchise if clueless as to the profit potential. The first thing a prospective investor asks the franchisor is likely to be: "how much does the franchise cost, and how much can I make?" Franchisors get around this conundrum in several ways. A common approach of franchisors who want to avoid a direct answer is to falsely state that the FTC prohibits making an earnings claim.[215] Many current franchisees are understandably reluctant to discuss their income, and may be embarrassed to tell even close friends if the business is failing.

In December 1994, the FTC brought three actions against franchise promoters. Entrepreneur Media, Inc., parent of *Entrepreneur* magazine[216] was cited for earnings claims violations[217] and assessed a

212. *See* Franchise.com *available at* http://www.franchise.com/fdc/template/buyer%2CResearchCenter.vm/a/z/display/78;jsession*Id.*=C37F72E1CF89F8CA677C9D87B093FC91.jvm1. The claim is not further attributed, making it impossible to determine the accuracy of the claim, and the context of the purported assertion. *Id.*

213. *Id.*

214. *See id.*

215. "[The] Rule does not compel franchisors to disclose such [earnings] information, it does require that franchisors who choose to make earnings claims must provide substantiation." Varney, *supra* note 193.

216. Entrepreneur Media also publishes Mexican and Japanese versions of *Entrepreneur*, and conducts seminars. *See* entrepreneurmag.com *available at*

$25,000 civil penalty.[218] Shulman Promotions (Own Your Own Business Shows) was cited for a similar violation and given a $10,000 penalty.[219] Blenheim Expositions, which ran the IFA Expo, was also cited for "misrepresentations about results of Gallup Poll on franchisee success."[220] No penalty was assessed, but Blenheim was required to print and distribute the FTC publication *A Consumer's Guide to Buying A Franchise*.[221] Implicit in the title of the publication is recognition that the majority view in the United States that franchise purchases are non-consumer transactions is not accurate. Tens of thousands of consumers purchase franchises, and for these non-commercial purchasers, the statements of a government agency are influential.

Several years ago, the authors were involved in the initial public offering of an Eatontown, New Jersey-based bagel franchise, and several franchisees became clients of the firm. Posing as prospective purchasers, we inquired of franchisees as to the state of their business. With one notable exception, all the franchisees that provided an opinion provided a favorable opinion. In discussions about these opinions with the franchisor's CFO, the CFO immediately named the dissatisfied franchisee and explained that the franchisor conducted anonymous surveys to find out what their franchisees were saying to "prospective buyers." The CFO also observed that the franchisee's candor was foolish: who would buy the franchise if the franchisee bad-mouthed the franchise? The truth was that most of the franchisees quickly lost most if not all of their investment. The franchisor subsequently went into bankruptcy.

In a 2003 Fairfield Research survey of 10,800 franchisees, 53% of franchisees did not consider their business a financial success.[222] A total

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http://www.entrepreneurmag.com/Home/HM_Static/1,4472,about_history,00.html. Entrepreneur Media is, not surprisingly, opposed to tightening the Franchise Rule as it applies to trade shows. *See* Letter from John M. Tifford, Esq., Rudnick, Wolfe, Epstein & Zeidman to Federal Trade Commission, *available at* http://www.ftc.gov/bcp/franchise/comments/95tiffor.htm.

217. FEDERAL TRADE COMM'N ENFORCEMENT OF THE FRANCHISE RULE, at 57, U.S. General Accounting Office, GAO-01-776, July 31, 2001 [hereinafter GAO 2001 Report].

218. *Id.* at 50.

219. *Id.*

220. *Id.* at 57. At issue was a claim commonly made by the IFA regarding the likelihood of success and average profits. *Id.* This is one of the few times the FTC disagreed with the IFA, however obliquely. *See* Varney, *supra* note 193.

221. *GAO 2001 Report* at 50.

222. Richard Martin, *Poll: Franchisees' Low Grades for Franchisors Even Lower Among Sandwich Shop Operators*, NATION'S RESTAURANT NEWS, Aug. 18, 2003, at 3, 8. Johnson Franchise Consulting, which paid for the survey, is headed by a former Schlotzsky's master franchisee now involved in litigation with Schlotzsky's. *Id.* at 8, 90. The survey was taken in May 2003 and results were tabulated from 1,000 randomly selected responses, no responses were received from McDonald's or Pizza Hut

of 73% of all franchisees said their profits were "lower" (29%) or "much lower" (44%) than forecast, with 88% of sandwich franchisees reporting their profits were "much lower."[223]

The CEO of Fairfield Research reported that in surveys of other industries he never received so many calls from survey subjects concerned about confidentiality: "You could tell [the franchisees] wanted to respond . . . but many were relatively hesitant, verging on paranoia."[224] There are valid reasons why a franchisee will not say anything negative to a stranger inquiring about the franchisor or the franchise opportunity. The discretionary power of franchisors is enormous. Franchisors frequently conduct audits of franchised outlets, often on a monthly basis. Such audits have a host of subjective criteria. Failure to achieve a specified score on the audit may result in penalties to the franchisee, including termination, meaning the loss of the franchisee's investment. In addition to the *Harford Donuts* case, the authors have heard from franchisees of Allied Domecq and other systems who allege selective enforcement of system standards and/or punitive encroachment. Franchisees who bad-mouth their system to prospects may even find themselves the target of a lawsuit for defamation or tortuous interference.[225]

Fast food remains the largest franchise category, with an investment requirement of $100,000-250,000.[226] The authors are aware of one restaurant franchisee who told prospects referred by the franchisor that they could earn 30% on their investment just as he did. An anonymous post in an Internet chat room also states that a particular restaurant franchisor's outlets earned 18% *after* taxes. Actual *pre-tax* income figures according to the National Restaurant Association are 6% for full service and 5% for limited service restaurants.[227] Franchisors often tout franchising as a "proven concept." In one such representation, the court found that "What had been 'proven' was that the concept of franchising was capable of returning large sums to the franchisor."[228]

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franchisees. *Id.* at 8.

223. *Id.* at 3.

224. Janet Sparks, *Debate Open Over Franchisee Survey Results*, FRANCHISE TIMES, Aug. 2003, at 60.

225. *Cf.* Magnetic Marketing Ltd. v. Print Three Franchising Corp., [1991] 38 C.P.R. (3d) 540, 568-569 (B.C.S.C.) (discussing franchisee bad-mouthing of the franchisor, the court noted that "misery loves company" and dismissed that portion of the franchisor's counterclaim).

226. Julie Flaherty, *By the Book: Individuality vs. Franchising*, N.Y. TIMES, Feb. 17, 2001, at C1, C4.

227. *The Restaurant Industry Dollar* (table), FRANCHISE TIMES, April 2001 at 26 (providing NRA Rest. Ind. Rpt 2000).

228. *Cf.* Bateman v. Slatyer (Feb. 25, 1987) No. NSW G351 of 1985, Slip Opinion, at ¶ 18 (N.S.W., Australia). Franchisee husband was flight attendant with no retail

Exhibitors at franchise Expos are disproportionately less well-known franchisors.[229] For such franchisors, the general perception of franchising as a statistically better bet than a non-franchised business is particularly important. Prospective franchisees are most likely to pay attention to the "empirical" industry-wide data presented by the Expo where there is a lack of franchise-specific information to inform a purchase decision.[230] People tend to rely on such data most heavily precisely when it is most foolish to do so.

Entrepreneur is hardly a paragon of journalistic objectivity, and the trade show is not the place to go for objective information, but to the uninitiated a newsstand magazine or a trade show affiliated with an association is perceived as a neutral source for information. Making earnings claims to financial and trade media outlets can be a means to circumvent FTC strictures, provided that the franchisor is careful not to directly give press clippings to franchisees.[231] For the FTC to pretend that purchasers of (for example) food franchises do not read the leading trade publication is disingenuous in light of the raft of franchisor advertisements in the back of *Nation's Restaurant News* (NRN) every week. When celebrity chef Wolfgang Puck announced plans to franchise, one of his directors was making claims of 36% profit margins in NRN before the offering circular was even filed with state regulators.[232] Another food franchisor, California-based Farmer Boys, announced its franchising push in an NRN interview making claims that franchisees had recouped their investment capital within two years and had experienced no franchise failures.[233]

As the American Franchisee Association noted, consumers see the newspaper first and then hear the franchisor say that the FTC prohibits

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experience. *Id.* Wife had worked in franchisor shop for two years. *Id.* As franchisees, wife worked 6 days/week and husband worked in shop on flight layovers. *Id.* They never showed a profit. *Id.*

229. Mary Jo Larson, *From Gumbusting to Geeky Guys: Expo Offers a Peek at Newest Franchises*, FRANCHISE TIMES, June-July 2000, at 4 (reporting that she "saw more large companies exhibiting this year . . . [b]ut, as with most IFE trade shows, there were the very small and very different franchisors in attendance").

230. *Cf*, Jonathan J. Koehler, *When Do Courts Think Base Rate Statistics Are Relevant?*, 42 JURIMETRICS 373, 396 (2002). "Individuating information reduces the perceived relevance of base rates, whereas the absence of individuating information focuses attention on available base rates". *Id.*

231. FTC Informal Staff Advisory Opinion No. 97-5 (July 31, 1997). *See also* David J. Kaufmann, Practice Commentaries, MCKINNEY'S CONS. NY LAW Art. 33, §§ 680-695 at 370 (noting that a *Wall Street Journal* interview making earnings claims was not in violation of NY law).

232. Amy Spector, *Puck Express Expands Through Franchising*, NATION'S RESTAURANT NEWS, June 11, 2001, at 4.

233. Amy Spector, *Farmer's* [sic] *Boy Cultivates Franchisees for Expansion*, NATION'S RESTAURANT NEWS, July 28, 2003, at 122.

earnings claims, the result is that franchisors sell with a set of publicized earnings claims they are contractually not liable for.[234] Professor Robert Perry interviewed Blimpie's executives who told Perry that in 1993 the average store gross was $239,000.[235] Perry dutifully repeated this in his book *The 50 Best Low Investment, High Profit Franchises*, and Blimpie's area developer used the book to sell franchises in northern California.[236] When one of the franchisees sued for disclosure violations, Perry testified on the franchisee's behalf and the franchisee won at arbitration. Given the costs of arbitration, most franchisees would give up; the victorious Blimpie's franchisee noted that the airfare and cost for a one-week arbitration in New York was $20,000.[237]

So if the franchisor will not make a claim in the UFOC, and the FTC tells franchisor trade shows to not make claims, and current franchisees are reticent to discuss their earnings, how is the prospect induced to buy? The "cocktail napkin" is a colloquialism that describes a meeting in which the salesman writes a number on a piece of paper and shows it to the prospective franchisee with a remark such as: "would you be happy if you made this much?" Of course, "[t]he strange thing about the napkin is that the franchisor always ends up with it."[238] A 2003 study disclosed that 44% of franchisee respondents said that profits were less than portrayed.[239] The general counsel to the IFA responded that only about 20% of franchisors make earnings claims, and "[i]f all these people are making illegal earnings claims I don't know why there are not hundreds of lawsuits that reflect that."[240] The answer is twofold: most people do not run to the courthouse in response to every franchisor action, and even if franchisees are aware that the earnings claim is illegal, proving a case in court is another matter; particularly in the face of an integration clause, which would render the "cocktail napkin" inadmissible, even if the franchisor was caught red-handed.

A franchisee not aware of the significance of an integration clause will mistakenly believe the franchisor is telling the truth and can be held accountable for the lies of the franchisor sales force. The court will look to the "well-drafted disclosure agreement," and the FTC will take no action so long as the UFOC disavows Article 19 earnings claims. Ultimately, the FTC has moved towards refusing to mandate the

234. Letter from Susan P. Kezios, Am. Franchisee Ass'n, to the Sec'y of the FTC (Apr. 30, 1997) *available at* www.ftc.gov/bcp/franchise/comments/kezios62.htm.
235. *Meanwhile, Over at Blimpie's*, FRANCHISE TIMES, June/July 2002, at 17.
236. *Id.*
237. *Id.* at 19.
238. JUSTIS & VINCENT, *supra* note 6, at 25.
239. Sparks, *supra* note 224.
240. *Id.*

inclusion of earnings claims in the UFOC. The move was applauded by the IFA, which nonsensically added that "the FTC is in a unique position to 'prompt' franchisors to voluntarily make earnings disclosures."[241]

A cautious franchisor will be certain to avoid language which would trigger FTC action, and will be sure to maintain possession of the cocktail napkin, as well as insert a merger and integration clause in the franchise agreement explicitly disavowing all prior statements and representations of the franchisor and the franchisor's agents.[242] A 2001 DecisionQuest survey of 600 persons found that 63% agreed with the statement: "[o]wning a franchise is a great way to get into business without taking a lot of risk."[243] The pollster observed:

> Of course, franchisor sales forces sound variations on this theme everyday, and opponents of new franchise legislation . . . frequently observe that franchising is healthy and needs no more government supervision precisely because the chances of success are far higher than in an independent business. However, this is not the thrust of any well-drafted disclosure document or franchise agreement . . . .[244]

A recent GAO report found that the FTC fails to take action except in limited circumstances. Generally, the FTC does not pursue cases against major franchisors, and even refers bona fide franchisor violations to a private association of the largest franchisors; the foxes are guarding the hen house.[245] Furthermore, although the FTC does not regulate the franchise relationship,[246] and therefore has no basis to make a judgment on the subject, the FTC told the GAO that there was no need to conduct a more widespread investigation.[247] From the perspective of the FTC, there is no problem with the franchise relationship, and hence no need to

241. Letter from Matthew R. Shay, IFA Chief Counsel, to the Sec'y of the FTC (May 16, 1997) *available at* www.ftc.gov/bcp/franchise/comments/final82.htm.

242. Integration clauses do not always defeat claim of earnings claim misrepresentation, *see* Sheskier v. Blimpie Int'l, Inc., Am. Arb. Ass'n Case 13 114 00309 00 (applying NY law), discussed in AFA BLAST FAX, Dec. 2001 *available at* www.franchsiee.org/blast.htm.

243. Cobo, *supra* note 172, at 184 (analyzing nationwide sample of persons qualified to serve as jurors).

244. *Id.* 183. Cobo notes that "the long-standing franchisor message about the attributes of this business form has apparently registered—perhaps too well." *Id.* at 182.

245. *GAO 2001 Report* at 7 (discussing the Alternative Rule Enforcement Program operated by the National Franchise Council (NFC)). *See also* NFC-FTC Alternative Rule Enforcement Program, *available at* http://www.nationalfranchisecouncil.org/about/ftc.htm. NFC was a trade group of 16 large franchisors which broke away from the IFA and subsequently was reabsorbed into the IFA. Janet Sparks, *IFA/NFC Merger Ends Long Dispute*, FRANCHISE TIMES, April 2003, at 50.

246. *GAO 2001 Report* at 8: "FTC staff told us [GAO] that the FTC generally lacks the authority to intervene in private franchise contracts and related relationship issues."

247. *Id.* at 42-43.

investigate or regulate, which means there is no record of problems. Even in the face of evidence from outside groups such as the American Franchisee Association, the FTC's pro-franchisor paradigm blinds it to post-sale overreaching. Psychologist James Hillman observed: "[t]he 'objective' idea we find in the pattern of data is also the 'subjective' idea by means of which we see the data."[248] The GAO report raises serious questions about the possibility of regulatory capture affecting the FTC's view of the data.

E. Targeting Prospective Franchisees

The franchising industry has taken note of regulatory slumber, and the consequence is that the least attractive franchisors seek out those members of the society who are least able to enforce what few rights are afforded them under the franchisor-drafted adhesion contract. Franchisors are advised to target those with little business experience such as young people and retired military, as well as "the corporate dropout"[249] whose 401(k) is a ready source of cash.[250] In an advertorial, the IFA notes that 75% of franchisees spent less than $250,000, 70% paid an initial fee of $30,000 or less, with fast-food fees averaging $20,000.[251]

When in court, IFA members claim that franchisees are sophisticated businesspeople, but the IFA's own data shows that franchisees usually start with small amounts of money. A rare example of a franchisor addressing this issue is the Blimpie Subs franchisor. In targeting poor neighborhoods, the Blimpie Urban Initiative for Leadership Development (BUILD) program solicited urban minorities

248. JAMES HILLMAN, RE-VISIONING PSYCHOLOGY 126 (1975).

249. MARY E. TOMZACK, TIPS & TRAPS WHEN BUYING A FRANCHISE 33 (1999). *See also Franchise Bug Bites Techies: Rather than Pound the Pavement, Pros Start Fix-it Shops for Home Computers*, CRAIN'S N.Y. BUS., Oct. 7, 2002, at 18; *see also*, Louis Uchitelle, *Pink Slip? Now, It's All in a Day's Work*, N.Y. TIMES, August 5, 2001, at BU1, BU3 (noting that fired employees think "it is an opportunity to go out on their own, . . . get control of their lives . . . that used to mean [consulting] or buying a franchise . . . neither was an easy road to success"); Beth Mattson-Teig, *Franchisees Buck Economic Woes*, FRANCHISE TIMES, June-July 2001, at 46 (the "growing potential for layoffs is a big incentive for self-employment, and the ability to control one's own destiny becomes increasingly desirable").

250. SDCooper Company, "Use your 401K or Rollover IRA to fund your new franchise," (Advertisement) in FRANCHISE TIMES, June/July 2003, at 53, *also available at* www.sdcooper.com.

251. *More Modest Proposals*, INT'L. HERALD TRIBUNE, May 5, 2002, (Sponsored Section page 23). IFA also notes that 250 franchises need investments of less than $50,000. *See* IFA, Press Release, Opening a Franchise Not As Costly As You Might Think (Aug. 7, 2001) *available at* www.franchise.org/news/pr/08072001.asp.

for franchise ownership, and waived the $18,000 franchise fee.[252] Viewing BUILD as an opportunity to develop a long-term relationship, Blimpie required candidates to pass a screening interview, attend a business development course, write a business plan, and find at least 5 possible franchise sites in addition to attending the standard franchisor training program.[253] BUILD garnered media attention because it *is not* the normal franchisor practice.

Some franchisees are publicly traded corporations with sufficient legal and financial resources to assess the viability of a particular opportunity.[254] However, franchisors normally target downsized employees,[255] retirees,[256] or immigrant[257] franchisees. Immigrants may place their trust in a recognized brand franchise, which may be misplaced as "some large franchisors target unsophisticated franchisees."[258] In *Sbarro Holding, Inc. v. Shien Tien Yuan*, a New York court described the relationship between the immigrant franchisees and the franchisor as "awesome" for the reliance placed by the franchisee on the franchisor.[259] A Canadian court also observed:

> The fifty plaintiffs in this case are all [franchisees] who operate Pizza Pizza stores in Ontario. Many of these people have come to Canada as immigrants or refugees, worked hard and saved money scrupulously, and then invested their life savings in the purchase of a Pizza Pizza outlet. Having obtained a franchise, they then work long hours, often in arduous conditions, in an attempt to earn a living from

252. *Blimpie Helps Franchisees Build Successful Businesses*, FRANCHISE TIMES, Nov.-Dec. 2000, at 6.

253. *See id.*

254. *See* James Peters, *S&P Downgrades Credit Ratings of Eight Struggling Operators*, NATION'S RESTAURANT NEWS, July 23, 2001, at 1, 11, 149 (noting that AmeriKing is the largest Burger King franchisee with 379 units).

255. Blimpie Int'l, Inc., "Up-Size Yourself," (Advertisement) in NATION'S RESTAURANT NEWS, July 9, 2001, at 79. The ad provides: "[c]orporate down-sizing got you down? Pick yourself up and call BLIMPIE". *Id.*

256. Kiplinger's Money Power, *Want a franchise? Here is Advice*, DESERET NEWS, July 22, 2001, at M04 (asking if persons have cash and are looking for "structure and purpose" after retirement).

257. Kaufmann, *supra* note 22 at 7 (citing Eric Dinallo, N.Y. Atty. General's Office, Chief of the Bureau of Investor Protection & Securities).

258. Dale E. Cantone (Deputy Securities Commissioner, Maryland Attorney General's Office), *State Review of Franchise Offering Circulars: A Continuing Cost-Benefit Assessment*, THE FRANCHISE LAWYER, Spring 2000, at 1, 2. *Accord*, LAWRENCE A. SULLIVAN & WARREN S. GRIMES, THE LAW OF ANTITRUST: AN INTEGRATED HANDBOOK § 8.2c2iii (2000) (discussing advertising); *see also* Hadfield, *supra* note 93, at 961-63. Of course, some franchisees become unsophisticated when advantageous: the "[franchisee] is neither uneducated nor unsophisticated despite his attempts in the witness box to appear so." Timothy's Coffees of the World Inc. v. Switt, 94-CQ-050117, 1996 Ont. C.J. LEXIS 2543 at *16 (Ont. Ct. General Div. 1996).

259. *See* Sbarro Holding, Inc. v. Shien Tien Yuan, 445 N.Y.S.2d 911, 914 (1981).

> their stores . . . the operation of a Pizza Pizza franchise is difficult and stressful work indeed.[260]

A professor of Law and Economics observed that rationality implies that the participants "know the nature of the environment in which they operate" and while complete knowledge may be lacking, participants "are aware of the extent to which they are ignorant."[261] The president of the IFA claims that he personally went to Subway's headquarters in 2002 "to check out the rumors that Subway sells franchises to uneducated immigrants," and pronounced that Subway founder Fred DeLuca had received a "bad rap" and "a sad hatchet job" in the press during the 1990s.[262] During the 1980s and '90s, the IFA exhibited no such concern: the IFA visited Subway *after* the bad publicity caused the franchisor to change its policies, and there is no other reported occasion where the president of the IFA has investigated franchisor overreaching.

Subway's attitude change is commendable, but it does not alter the fact that abuses occurred for decades while Subway was in the process of growing into the largest restaurant franchise in the United States. The rise of Subway in the wake of such abuses indicates the need for legislative action to prevent recurrence. In 1998, the head of franchisee training for Subway said that 30% to 50% of his franchisees were immigrants, and when Subway began testing for English and basic math proficiency, 35% of applicants failed the tests.[263] Noting that many were "clueless" about their obligation to make weekly royalty payments and other matters, the Subway executive continued: "[o]ne-third of the students have no illusions. The rest have huge gaps in knowledge, don't do their homework, or don't know what questions to ask. It's mind boggling.[264]

Particularly for unsophisticated individuals of lower socioeconomic status, ownership of a household-name franchise conveys a degree of status and may result in a non-rational purchase decision.[265] At a recent meeting of franchise attorneys, this author asked a prominent franchisor attorney from Richmond, Virginia what he would say to an immigrant franchisee with a limited command of English who did not comprehend

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260. Ontario Inc. v. Pizza Pizza Limited, No. 93-CQ-33541, B85/93, 1995 Ont. C.J. LEXIS 968 at *2 (Ont. Ct. of Justice 1995).

261. Avery Katz, *The Strategic Structure of Offer & Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 235 (1990).

262. Julie Bennett, *A Wild Ride: Subway's Rise to Respectability*, FRANCHISE TIMES, Oct. 2003, at 14, 17.

263. Behar, *supra* note 46, at 130.

264. *Id.*

265. *Cf.* PINKER, *supra* note 25, at 303 (citing work of economist Robert Frank, acquisition of status items).

the UFOC but relied on the representations and reputation of a nationally-known franchisor, which then took post-contractual advantage of the franchisee. The franchisor attorney responded: "[t]ough." If empathy is "the unseen glue that holds civilization together,"[266] lack of empathy tears the franchise relationship apart.

Unsophisticated franchisees may be susceptible to a "halo effect" where the discount rate ascribed to the franchising as an industry is distorted by application of the discount rate ascribed to franchised products.[267] A powerful franchise brand further distorts analysis of the franchise investment. The halo effect becomes particularly pronounced at the level of the specific brand. Trademark owners are acutely aware of reputational risk as applied to the brand value of the retailed product,[268] but inefficient dissemination of reputational data with regard to the wholesaled product (franchises) mean that franchisors can benefit from an unsophisticated consumer's perception that if Dunkin' has quality donuts and if Burger King is concerned about the humane treatment of cattle, then the consumer's positive perceptions of the brand carry over to the consumer's perception of the franchise. Regardless of whether this is a rational heuristic; it is a process which must be considered in the regulation of the franchise industry.

Franchise attorney Andrew Selden, who represents some of the largest franchisee associations in the United States, notes that the household-name franchises attract naive individuals who ignore the litigation history only to discover post-sale that they are at the mercy of "systems where the franchisors have megalomaniacal attitudes . . . try and control everything, and . . . take opportunistic advantage of their franchisees."[269] A Canadian court noted that one founder:

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266. Judy Foreman, *I Feel Your Pain*, NY DAILY NEWS, Sept. 8, 2003, at 43, 44 (quoting psychologist Andrew Meltzoff of the University of Washington).

267. This kind of cognitive bias is a form of anchoring. *See* Mark Snyder et al., *Social Perception and Interpersonal Behavior: On the Self-Fulfilling Nature of Social Stereotypes*, 35 J. PERSONALITY & SOCIAL PSYCHOL. 656 (1977) (finding that new information was fit into preexisting conclusion).

268. *Cf. Mug Shot: Coffee Companies Prepare for a Roasting*, ECONOMIST, Sept. 21, 2002, at 63 (stating that companies have to "give in to . . . spurious cries [of unfairness to growers], unless they want to gamble with 'reputational risk' i.e., having their names tarnished in the media"). The concept of the trademark as more than mere indicia of origin first appeared in F.I. Schechter, *The Rational Basis of Trademark Protection*, 40 HARV. L.REV. 813 (1927).

269. Janet Sparks, *Is litigation in Franchising on the Decline?*, FRANCHISE TIMES, Nov./Dec. 2002, at 50. In their attitude towards the relationship between the dominant franchisor and submissive franchisees, and denial of constraints imposed by moral norms, franchisors are worthy heirs of Nietzsche. And as with their rejection of relationship regulation on laissez-faire grounds, the franchisor philosophy of franchisee relations is not in tune with the views held by the broader society in which the franchise industry operates.

> viewed the franchise network much like a personal fiefdom over which he was entitled to rule with absolute and unfettered authority. The franchisees were expected to follow his directives and decisions without question and certainly without opposition . . . any franchisee who had the temerity to question the decisions of the [franchisor] could expect to have the full weight of the [franchisor] brought down upon its head . . . .[270]

Questioning franchisor decisions can be fatal to a franchisee. An Australian court held that where a franchisee disagreed with a franchisor remodeling program but subsequently assented to franchisor demands, the franchisee could be terminated since mere "criticism of certain aspects of the program"[271] by the franchisee led to a "loss of confidence [that] would not necessarily be overcome by a change in attitude on the part of [the franchisee]."[272] Some Rhode Island franchisees who drove to their franchisor's headquarters to complain about encroachment claimed that they were singled out after the visit; five years later one told a reporter "I'm still afraid to talk to you."[273]

Huge multinational franchisors have the financial, political, and legal resources to look out for their interests, both pre and post-contract. It is even more shameful that franchisors target those most vulnerable, who are ignorant of American law and custom. Particularly in Asian culture, personal honor is at stake in business relationships, and the signed agreement is but one piece of evidence of the parties' desire to form a relationship.[274] Many non-Western nations take a different view of contractual ethics:

> To Koreans, a contract represents the current understanding of a "deal" and is the beginning of negotiations with a Korean partner, not the end of discussions . . . . This has led many foreigners to believe that Koreans do not place the same importance on a contract as Westerners do.
>
> Though Americans may regard a contract as legally binding, a

270. Shelanu Inc. v. Print Three Franchising Corp., [2000] O.J. No. 591 (C.J. (Gen. Div.)), 2000 Ont. Sup. C.J. LEXIS 2369 at *51-52.

271. Garry Rogers Motors (Aust) Pty Ltd. v. Subaru (Aust) Pty Ltd., (1999) FCA 903, *available at* 1999 Aust Fedct LEXIS 495 at *24.

272. *Id.* at *25.

273. Behar, *supra* note 46, at 132.

274. *See* Jeswald W. Salacuse, *Renegotiating International Business Transactions: The Continuing Struggle of Life Against Form*, 35 INT'L LAW. 1507, 1513-14 (2001) (citing Philip J. McConnaughay, *Rethinking the Role of Law and Contracts in East-West Commercial Relations*, 41 VA. J. INT'L L. 427 (2001); Jeswald W. Salacuse, *Ten Ways that Culture Affects Negotiation*, 14 NEG. J. 221, 225-27 (1998); LUCIAN PYE, CHINESE NEGOTIATING STYLE (1982)).

> Korean may regard the same contract as a "gentlemen's agreement" which is subject to further negotiations dependent upon new circumstances. Therefore, contract negotiations with Koreans should be viewed as a process of extensive dialogue with the objectives of (1) reaching a common understanding on the deal and of each party's responsibilities; (2) putting that detailed understanding on paper; and (3) being prepared to modify the meanings of the terms afterwards, as conditions change.[275]

Immigrants now comprise 1 in 10 Americans[276] and are a prime target of franchisors. Traditionally, major cities such as New York were the initial home of poor and unsophisticated arrivals. Even today 37% of New York's population is foreign-born and 14% of households include at least one undocumented person.[277] Air travel and changing patterns of immigration have resulted in an immigrant population that is more dispersed,[278] and wealthier[279] than previous generations. If you stop at a roadside hotel in Georgia, there is a 45% chance it is owned by an immigrant from India.[280] Franchise journalist Janet Sparks observes that "some franchise industries have already come to depend on different ethnic/racial groups to run their businesses;" Sparks adds that the economy hotel industry "survived" by getting Asian American franchisees to pool family money and buy hotels, which provided jobs and living quarters.[281] By 2003, the Asian American Hotel Owners Association members accounted for more than 50% of economy properties and nearly 37 % of all hotel properties in the United States.[282]

Immigrants have traditionally suffered discrimination and been

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275. U.S. FOREIGN AND COMMERCIAL SERVICE AND U.S. DEPT. OF STATE, COUNTRY COMMERCIAL GUIDE (KOREA) (1998) *available at* www.buyusainfo.net/adsearch.cfm.

276. *Labels in English Pose Risk in Multilingual Nation*, N.Y. TIMES, May 20, 2001, at A30 (citing the 2000 Census). A Franchisee's inability to read the tortured legalese of a UFOC is another reason why franchisor targeting of immigrant groups is in the franchisor's interest.

277. Susan Sachs, *Mayor's New Immigrant Policy, Intended to Help, Raises Fears*, N.Y. TIMES, July 23, 2003, at 1.

278. Mark Bixler, *Indians States Largest Asian Group; Entrepreneurial opportunity, High-tech Jobs Fuel Boom*, ATLANTA JOURNAL & CONSTITUTION, May 27, 2001, at 6G (noting populations of 46,000 Indians, 29,000 Vietnamese, 28,700 Koreans, and 27,500 Chinese in Georgia).

279. Susan Sachs, *Welcome to America, and to Stock Fraud*, N.Y. TIMES, May 15, 2001, at A1(stating that an "[i]ncreasing number of immigrants have arrived with substantial savings to start their new lives").

280. Bixler, *supra* note 278 (quoting Mike Patel of the Asian-American Hotel Owners Association).

281. Janet Sparks, *Minority Programs: Hype or Help?*, FRANCHISE TIMES, Aug. 2001, at 12.

282. Janet Sparks, *7-Eleven Coalition Shocked by New Corporate Restrictions; AAHOA Increases Membership, Toughens Position*, FRANCHISE TIMES, Sept. 2003, at 50.

targeted by schemes to quickly part them from their savings.[283] Further, immigrants coming from nations which have franchised businesses may not be aware of significant differences in American franchise regulations.[284] Although many immigrants come from English–speaking nations such as India, many immigrants (including many from India)[285] are not fluent in conversational English, let alone the technical and legal English found in franchise agreements. Lack of fluency in English[286] remains a barrier to integration in the workforce, and social norms impose a responsibility on the more successful members of the extended family to assist the group.[287]

Franchising can be an excellent avenue for entrepreneurial immigrants to achieve success that would otherwise be difficult. It is a risky avenue, however. Lacking the access to customary credit resources, many immigrant families pool their savings to buy a franchise.[288] While the extreme case is the immigrant in bankruptcy who borrowed money from his brother-in-law to buy a franchise,[289] highly leveraged purchases and intra-family lending, particularly among immigrants, has been commonly observed by this author as a franchisee. Limited financial resources may lead many to avoid the cost of a legal review of the franchise contract. Furthermore, the FTC disclaimer may have the opposite of the intended effect on a prospective purchaser. The FTC disclaimer, a thick legal document stating that it has been filed with

283. Susan Sachs, *Welcome to America, and to Stock Fraud*, N.Y. TIMES, May 15, 2001, at A1 (stating that "[w]hen it comes to separating immigrants from their money, few techniques have gone untested").

284. In India, for example, there are regulations governing the maximum franchise fee and royalty payments remitted to U.S. franchisor bank accounts, and these payments must be approved by several agencies. *See* U.S. FOREIGN & COMMERCIAL SERVICE & U.S. DEPT. OF STATE, COUNTRY COMMERCIAL GUIDE (INDIA) (1999) *available at* http://infoservv2.ita.doc.gov/tcc/InternetCountry.nsf/baee3c88ac11f4628525653a0071d106/.

285. Even where English is the lingua franca of business, it is often not the native tongue of immigrants. In India, Hindi is the national language, and there are 24 total languages spoken by a million or more persons. *See* THE WORLD FACTBOOK *at* http://www.cia.gov/cia/publications/factbook/geos/in.html.

286. This is a problem in the U.S., *Labels in English Pose Risk in Multilingual Nation*, N.Y. TIMES, May 20, 2001 at A30 (1990 Census showed 8.3% of households had no person over age of 14 who spoke English well).

287. A wealthy immigrant doctor purchased a bagel franchise in Brooklyn Heights. When the franchise incurred substantial ongoing losses, the author of this paper asked the doctor why he did not sell. The doctor explained that as the "success" of his family, he was responsible for their care and that charity would be demeaning. The doctor said he was willing to incur modest losses, if it meant that the extended family would have jobs. This may be an extreme case, but in the author's experience it is not unique.

288. *See* Bixler, *supra* note 278.

289. *See* Lee v. Hasty Market Inc., File No. 8536/84, 1993 A.C.W.S.J. LEXIS 49674 (Ont. Ct. of Justice 1993).

the Federal Trade Commission, may lead to the assumption that there is government oversight of the franchisor.[290] Franchisors prey upon this ignorance; many will say, for example, that they cannot provide an earnings estimate because the FTC prohibits the practice.[291] Apart from the fact that such a statement is not true,[292] the prospective franchisee is left with the impression that the franchise sales process is actively regulated when in fact regulation, such as it is, consists primarily of the disclosure requirement. FTC regulation does not address statements the franchisor makes with the knowledge that the integration clause will generally eliminate any recourse by an aggrieved franchisee, although a proposed FTC rule would specifically outlaw the practice. Until then, as a Canadian judge noted:

> [w]hat would be the situation if [the franchisor] had instructed its draftsman to prepare its standard form contract in such a way as to give it the leeway that it claimed in this instance was present and the draftsman had succeeded in doing so by employing skill and care? I think it is helpful for franchisees that they would likely be facing the parol evidence rule . . . . Not everyone is aware of the niceties of the parol evidence rule. While there are exceptions to it, the careful skilled draftsman can almost always avoid such exceptions with enough fine print.[293]

An attorney with two decades of experience observed: "this longstanding rule of contract law is used knowingly in an effort to avoid responsibility for franchise fraud and disclosure law violations. The policy underlying the [Franchise] Rule ought not to be thwarted so easily."[294]

F. Labor Issues

Freedom of contract in the United States reached its apogee in

290. How much oversight is exercised is a matter of debate and the subject of a recent General Accounting Office (GAO) audit. *See* GAO 2001 Report *supra* note 217.

291. The author has attended sales seminars where this was done. In fairness, many franchisor salespersons honestly believe this is the law and are surprised to find otherwise. At a seminar in June 2001, an FTC employee told this author that the claim by franchisors that the FTC prohibited earnings claims was such a frequent problem that the FTC was considering issuing written guidance to stop the practice.

292. The only requirement is that if a franchisor chooses to make claims, they must comport with Franchise Rule §§ 436.1(b-e). *See* Interpretive Guides to Franchising & Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966 (Aug. 24, 1979).

293. Head v. Inter Tan Canada Ltd., [1991] 5 O.R.3d 210-11.

294. Letter from L. Seth Stadfeld to the Sec'y of the FTC (Dec. 21, 1999) *available at* http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment023.htm.

Lochner v. New York.[295] Poor immigrant bakers were working 90 or more hours per week in "bakeries" set up in the basements of tenement buildings in lower Manhattan. Lacking adequate ventilation, the workers suffered from oppressive temperatures and disease, many slept on sacks of flour in the basements. Without money or negotiating power, the workers were at the mercy of employers who took advantage of their superior bargaining position. The government sought to stop this, but was opposed by employers who claimed that if the conditions were unacceptable, the workers were free to work elsewhere and the government had no right to interfere with freedom of contract. One can substitute "franchisees" for "workers" to hear the franchisor argument against regulation. Reliance on the good faith of franchisors in the absence of explicit legislation is likely to be less successful than reliance on the good faith of the *Lochner* employers due to franchisees' large sunk costs and noncompete covenants. Perceptions that unfettered freedom for those powerful enough to dictate the terms of the contract leads to results detrimental to the interests of society and causes changes in jurisprudence.

As early as 1890, the Sherman Antitrust Act[296] recognized that public policy concerns might limit freedom of contract. American law also recognized that a powerful party could force a weaker party to "agree" to a contract containing terms that were illegal.[297] As the Progressive movement took hold during the twentieth century, restrictions on freedom of contract were a natural result.[298] The Supreme Court overruled *Lochner* in 1937.[299]

There is little doubt that *Lochner* would be decided differently today; societal norms provide for limits on the employer's right to freedom of contract. Congressman LaFalce compared proposed franchise legislation to the Wagner Act, and noted that just as the Wagner Act had brought fairness to the employment relationship in the early days of big business, so too could the SBFA bring fairness to franchising as the franchise industry becomes a major component of the

295. Lochner v. New York, 198 U.S. 45 (1905). *See also* PAUL KENS, LOCHNER V. NEW YORK: ECONOMIC REGULATION ON TRIAL (1998).

296. 26 Stat. 209 (1890), *codified at* 15 U.S.C. § 1.

297. *See* Times-Picayune Pub. Co. v. United States, 345 U.S. 594, 608-09 (1953) (discussing tying arrangements, an issue in franchising agreements to this day). *See also* Louis B. Schwartz, *The Schwartz Dissent* (to the Attorney General's Nat'l Committee to Study the Antitrust Laws), 1 ANTITRUST BULL. 37, 47 (1955) (describing power of automobile franchisors to prevent entry of competitors by means of pressure on franchisees).

298. *See generally* BARBARA H. FRIED, THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE: ROBERT HALE AND THE FIRST LAW AND ECONOMICS MOVEMENT (1998).

299. West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937).

global economy.[300] Franchisors claim franchising is not an industry and hence cannot be regulated; but labor is not an "industry" and yet we have labor laws applicable to every business in the country. Increasingly, the traditional employer-employee relationship has evolved to alternatives such as franchising, outsourcing, independent contractor arrangements, and the like. With evolution has come a revival of century-old debates: "franchising has been the subject of polarization reminiscent of the early battles between management and organized labor,"[301] and the ability of franchisors to force franchisees to continue working at an unprofitable franchise or risk facing huge awards is similar to indentured servitude and was even compared to "enslavement" by the *Sealy* court.[302] Conversely, the ability of a franchisor to encroach upon a franchisee who has built a successful business, or to force the franchisee to sell below market, should be contrasted with recent trends in employment law holding that employment-at-will contracts cannot be used as a means of depriving an employee of benefits already earned.[303]

Franchising is not only a non-traditional source of access to the capital markets[304] but to the labor markets as well. A leading franchisor attorney tells his clients that "[f]ranchise investments are scrutinized and evaluated against comparable business opportunities, competing alternative employment options and robust returns in capital markets."[305] Franchise sales boom in times of rising unemployment.[306] Although franchisor attorneys see "businesspeople who have decided to seize entrepreneurial opportunities,"[307] the franchise industry knows that many

300. *Franchising Relationship*, *supra* note 49, at 10, 13 (statement of Hon. John J. LaFalce (D-NY)).

301. Byron E. Fox & Henry C. Su, *Franchise Regulation: Solutions in Search of Problems?*, 20 OKLA. CITY U.L. REV. 241, 244 (1995).

302. *See* Postal Instant Press, Inc. v. Sealy, 51 Cal. Rptr. 2d 365, 373 (Cal. Ct. App. 1996). In that case, the franchisee fell delinquent in royalty payments. *Id.* In the authors' experience, it is common for franchisees to toil for little money while paying substantial royalties to franchisors.

303. Metcalf v. Intermountain Gas Co., 778 P.2d 744, 749 (Idaho 1989) (quoting Wagenseller v. Scottsdale Memorial Hosp., 710 P.2d 1025 (Ariz. 1985)).

304. Carolyn Walkup, *Jimmy John's 'Delivers' on Growth*, NATION'S RESTAURANT NEWS, Jan. 14, 2002, at 1, 6 (franchisor notes use of franchisee capital makes franchising more attractive than company outlets).

305. Lane Fisher & Cheryl L. Mullin, *Searching for Tomorrow's Franchisees*, *available at* www.franchise-law-firm.com/articles/article1.html.

306. Jerry Wilkerson, *Franchising Likely to Grow as Recently Jobless Seek to Mind Their Businesses*, NATION'S RESTAURANT NEWS, May 26, 2003, at 27 (projecting 4-5% annual growth "as the recently unemployed seek to establish their own businesses"). *See also* Christopher Swan, *UK Sees Slide in Growth as US Advances*, FINANCIAL TIMES (London), June 26, 2001, Tuesday Surveys at 11 (noting that layoffs spur franchise purchases).

307. Edward Wood Dunham, *Flattery Will Get You Nowhere*, 20 FRANCHISE L.J. 103 (2001).

franchisees are "buying a job."[308] A recent *New York Times* article titled "*To Get a Job, Become a Boss: The Lure of Owning a Franchise*" noted that "many people opening new franchise outlets are also new to owning a business."[309] An e-mail for the British Franchise Association exhibit proclaims "[s]ack your boss!" and promotes franchising "as one of the safest methods to start or even expand your own business."[310]

For new franchisees whose work experience is in a traditional employment setting, a franchise is often looked at as a job from which one cannot be laid off. Franchisees often use severance and 401(k) monies to buy their franchise, leaving them in a precarious position in the event of franchise failure. A recent session of the International Bar Association reported that Venezuelans are buying franchises with their unemployment checks,[311] and the U.S. Department of Commerce notes that the growth of franchising in Argentina from 1993 to 1996 was spurred by "massive job layoffs" as companies were privatized, as well as an Argentine Supreme Court ruling that franchisors were not subject to provisions of the Argentine Employment Agreements Act.[312] In Germany, concerns that franchising was being used to have "employees in disguise" (thereby circumventing Social Insurance payments) led to passage of a law defining the terms under which the franchisor could escape liability for payments on the franchisee's behalf.[313] Vertical disintegration[314] of the labor market is a particularly sensitive issue in countries which have greater employee protections than the United States. But, labor market disintegration is also an issue in the U.S. as rising statutory minimum and "living" wage requirements, FICA, and

308. Erika Friday, *Desert Moon Looks to Grab Bigger Bite of Fast-casual Mexican Niche*, NATION'S RESTAURANT NEWS, May 19, 2003, at 188, 189 (quoting Desert Moon senior vice president of Operations on why he looked for multi-unit and not single unit owners). The phrase multi-unit owner is common in the franchise industry, although rarely in an attributed quote.

309. Sharon McDonnell, *To Get a Job, Become a Boss: The Lure of Owning a Franchise*, N.Y. TIMES, April 27, 2003, at Section 10, page 1.

310. E-Mail from Fran News to FranMail list (Aug. 14, 2001, 5:46 a.m.) (on file with author).

311. Philip F. Zeidman, *An indespendable Way to Find out What's Happening in the World of Franchising*, FRANCHISE TIMES, Nov.-Dec. 2000, at 54.

312. U.S. DEP'T. OF COMMERCE, INT'L. TRADE ADMINISTRATION, COMMERCIAL SERVICE, NATIONAL TRADE DATA BANK, MARKET REPORTS, FRANCHISING IN ARGENTINA, Jan. 16, 1996 (citing Rodriguez v. Argentine Bottling Co. & Pepsicola Arg., CSJN, No. 45,158, April 15, 1993, and noting applicability of § 30 of Argentine Employment Agreements Act (LCT)).

313. FIELD FISHER WATERHOUSE, FRANCHISING UPDATE: FOCUS ON GERMANY (Summer 2001) (on file with author) (noting 5-factor test).

314. Vertical disintegration is a term coined by Hugh Collins. *See* Hugh Collins, *Independent Contractors and the Challenge of Vertical Disintegration to Employment Protection Laws*, 10 OXFORD J. LEGAL STUD. 353 (1990).

regulatory regimes such as the FLSA, the FMLA, and the ADA, raise the economic cost of the traditional methods of labor procurement.[315]

Non-traditional labor procurement enables corporations to maintain control without the statutory and economic costs, as an Australian professor noted, "arms-length" procurement such as franchising and licensing is seen as an alternative to traditional investment in branches and subsidiaries.[316] In addition, non-traditional labor is easier to control, particularly where traditional labor (employees) would have statutory or constitutional protections.[317] Vertical disintegration of employment laws is not simply an academic curiosity, it is franchise reality:

> [I]n the view of many experts, the modern franchise agreement severely stretches the legal requirements for an independent contractor relationship. In some instances the Department of Labor, the Small Business Administration, and the Federal Trade Commission have denied franchisees recognition as small businesses because the franchisor exercises total control over the business enterprise.[318]

Professor Collins' observations regarding workers deemed "independent contractors" is applicable to franchisees tightly controlled in all aspects of work by the corporate franchisor:

> [T]he underlying cause of the difficulty experienced by the courts in policing the boundary between employment and independent contractors springs from the vicious combination of the source of

315. Alan L. Fuchsberg, *Temporary Employees Gaining Traditional Rights & Remedies: Emerging Body of Law Addresses Use of Alternative Forms of Labor*, N.Y. L.J., March 10, 2003, at 7.

316. Paul Redmond, *Transnational Enterprise and Human Rights: Options for Standard Setting and Compliance*, 37 INT. L. 69, 77 (2003).

317. A recent example can be seen where American municipalities outsource functions and then attempt to control the free speech of the labor purchased on the grounds that the relationship is that of an independent contractor and not employee-employer. The Supreme Court disagreed in Bd. Of County Comm'rs v. Umbehr, 518 U.S. 668, 684 (1996), but some courts have followed *Umbehr* narrowly. Franchisees are graded by subjective evaluation criteria, and are in a more tenuous position than similarly situated employees, private or municipal. For example, a franchisee attempting to form a franchisee association has far less protection than an employee attempting to unionize.

318. Purvin, *supra* note 180, at 10. There are several tests to determine if a worker is a true employee as opposed to an independent contractor. The Internal Revenue Service factors are set forth in IRS Form SS-8, and the leading case on the issue is Nationwide Mutual Ins. Co. v. Darden, 503 U.S. 318 (1992). Extensive control by the franchisor, inherent in the very nature of franchising, risks the imposition of vicarious liability. *See Franchisor Liability*, 39 POF 2d § 3. Franchisor attorneys have argued that courts should distinguish between "controls implicit in the franchise relationship" and "operational control." *See* Kevin M. Shelley & Susan H. Morton, *"Control" in Franchising and the Common Law*, 19 FRANCHISE L.J. 119, 120 (2000). In the author's personal franchise experience, such a distinction is often difficult to make.

> legitimacy of the courts' decisions in deference to the parties' choice and the employer's ultimate power to shape the terms of contracts and determine the size of the organization. Armed only with discourses framed in terms of respect for freedom of contract, the courts cannot successfully impose employment protection rights, for every test of employment becomes disfunctional [sic] in the long run.[319]

A measure of the high stakes involved in the labor debate is evidenced by *In the Matter of Francis*,[320] where a bathroom janitor in rural New York claimed unemployment benefits. The amount of benefits at issue was modest, but when the Commissioner of Labor, an Administrative Law Judge, and the Unemployment Insurance Appeal Board all held that the "franchisee" was actually an employee, the IFA's Washington, D.C. law firm filed an *amicus* brief, and the franchisor's appeal was handled personally by the senior partner of the leading franchise law firm in New York. The court found that although the contract specified that Glenroy Francis was not an employee, the contract was not dispositive; as a result, the court upheld the unemployment Board's finding of an employee-employer relationship.[321] Cynthia Feathers, Mr. Francis' attorney, noted that such claims involved only a few thousand dollars and that in her years of practice this was the only time she knew of an *amicus* brief in an unemployment claim case.[322]

Four years after the New York case, a distributor for Mary Kay won a Texas jury verdict of $11.25 million after the plaintiff showed that she was subject to the control of Mary Kay and that her classification as an independent contractor saved the company significant costs and enabled Mary Kay to avoid compliance with California law.[323] Hard facts probably helped the plaintiff; after Claudine Woolf missed work due to a debilitating form of breast cancer while pregnant, Mary Kay towed her car and threatened termination.[324]

In a New Zealand case, where the employment tribunal and the trial court accepted the vertical disintegration theory by holding an independent contractor relationship to be subject to employment law; the

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319. Collins, *supra* note 314, at 376-77.

320. 688 N.Y.S.2d 55 (N.Y. App. Div. 1998) (the "franchisor" was West Sanitation Services, Inc.).

321. *Id.* at 56.

322. Telephone Interview with Cynthia Feathers, Esq. (Oct. 13, 2003).

323. Woolf v. Mary Kay, No. 00-5612-J (Sup. Ct. City of Dallas Nov. 21, 2002). *See also* Reni Gertner, *Saleswoman with Cancer Denied Leave, Awarded $11.25M*, LAW.WKLY. USA, Jan. 6, 2003, at 1, 18 (the suit alleged violation of the California Fair Employment and Housing Act).

324. *Cosmetics Company Loses Face in Discrimination Claim*, TRIAL, March 2003, at 83, 84.

Court of Appeal reversed but noted approvingly the lower court comment that parties could contract as employer-employee or employer-contractor and that from the employer's standpoint, the work got performed either way.[325] While the tribunal and lower court felt that this justified looking to the purpose of the relationship rather than the language of the contract, the Court of Appeal held that as long as the contract was not a sham it was the province of the legislature to react to changes in the procurement of labor.[326] An Australian court facing similar facts held that "the minutia of detail" in the agreement rendered the worker an employee and not an independent contractor,[327] and cited a case involving the Weight Watchers franchisor, where the franchisee was "tied hand and foot by the contract" in the manner in which the franchisee performed work.[328] More recently, in the *Ekis* case, Australia moved away from the "control" factors and looked towards other factors such as the investment of the franchisee *cum* employee; simultaneously noting that the inquiry can be very fact-specific and noting, as did the New York court in *Francis* that such matters are best left to the labor authorities.[329]

The issue of franchisor control is more frequently raised by third parties seeking to impose vicarious liability, and the factual bases for such claims may be used as a foundation for finding the existence of a quasi-employment relationship. A Brooklyn court found that Coldwell Banker's degree of control over franchisees raised triable issues of fact as to whether the franchisee was an agent of the franchisor, noting *inter alia* "that the franchise must be operated in accordance with a voluminous policy manual provided by [the franchisor]."[330] While courts may continue to find the existence of a common law employer-employee relationship on a case-by-case basis, these are not questions that courts should routinely be called upon to resolve.

Legislative failure to recognize the economic and non-economic

325. TNT Worldwide Express (NZ) Ltd. v. Cunningham, [1993] 3 N.Z.L.R. 681 (Ct. App. Wellington), *quoting* and *rev'g* [1992] 3 E.R.N.Z. 1030, 1035 (Employment Court) and the employment tribunal decision *repeated at* [1992] 1 E.R.N.Z. 956.

326. *Id.*

327. Vabu P/L. v. Comm'r of Taxation (1995) No. BC9504402 1995 NSW LEXIS 11223, at *21 (describing applicability of Superannuation Guarantee (Administration) Act of 1992).

328. *Id.* at *15 (citing Narich P/L v. Comm'r. of Taxation (1983) 2 N.S.W.L.R. 587, 606).

329. Sec'y, Dept. of Social Security v. Ekis, (1998) 52 A.L.D. 246.

330. Friedler v. Palyomis, N.Y.L.J., July 16, 2003 at *21 (Kings Sup. 2003) (on file with author). The court also noted the supervision and training provided by the franchisor to the franchisee and franchisee employees, and the separate issue of whether a customer of the franchise would believe that the franchisee was an agent of the franchisor. *Id.*

reasons which underlie the new methods in which labor is purchased allow for abuse. Legislators need to initiate a debate on the new economy and the degree to which opportunistic behavior permitted by contract should be restrained by statute. Current regulatory views fail to take into account the new labor purchasing paradigm. The New York State Attorney General's Office issues a laissez-faire paean to franchising as an avenue to the "American Dream"[331] while at the same time the Attorney General notes that immigrant workers are "easy prey" who need the government to regulate their income.[332]

The Attorney General notes that government regulation has "managed to change the context" in which immigrant laborers work,[333] and that is true. Today, a smart corporate purchaser of labor will purchase labor by means of a franchise agreement and thereby capture the "easy prey" without any interference from the government. This is particularly true in low-skilled labor-intensive operations such as food service. Burritoville was a non-franchised successful Mexican quick-service restaurant (QSR) whose units averaged $800,000 annually, but which failed to pay its (mostly Hispanic) workers overtime.[334] Following an investigation by the N.Y. Attorney General, the company was forced to sell to franchisor TruFoods Corp., which agreed to assume $500,000 in liabilities to the workers.[335] Given the labor economics of a QSR under government scrutiny, the new owners of Buritoville have a sensible plan, to franchise.[336] TruFoods, which also operates Arthur Treacher's Fish & Chips and Pudgie's chicken outlets, hired a union officer as director of labor relations in order to *fight* unionization efforts at Burritoville.[337]

One of the authors was witness to a case where a worker went to work "off the books" for a franchised QSR and filed an unemployment claim against her previous employer. The previous employer called the

331. Kaufmann, *supra* note 22 (quoting Eric Dinallo, Chief of the Bureau of Investor Protection and Securities, Office of the N.Y. Attorney General).

332. William Rainbolt, *Attorney General's Success Shows Flaw in "Chicago School" Theory*, N.Y.S.B.A. NEWS, March/April 2003, at 34. Spitzer's official bio, in the fourth sentence, boasts: "He reached landmark settlements with employers to protect the rights of workers." *See* N.Y. RED BOOK 794 (96th ed. 2001). In one case, an Assistant A.G. personally distributed checks in a bakery vestibule with media in tow. *See* Ronald Drenger, *Hudson Market Workers Win Back Wages*, TRIBECA TRIB, Jan. 2002 at 6.

333. Rainbolt, *supra* note 332.

334. Lisa Fickenscher, *Reheated Burritoville Set to Feed East Coast*, CRAIN'S NEW YORK BUSINESS, May 26, 2003, at 14.

335. *Id.*

336. *Id.*

337. Juan Gonzalez, *Union Boss & Buster All in One*, N.Y. DAILY NEWS, July 10, 2003, at 14 ("[b]y night he was a union leader, and by day he led Burritoville's efforts to defeat his own union").

QSR franchisor's corporate office to complain, and was referred to a franchisor paralegal who began by disclaiming any responsibility for the franchisee paying an employee "off the books" since the franchisee was independent of the franchisor. When the employer stated that his company would demand a hearing before the Unemployment Compensation Board, the franchisor paralegal asked the employer: "[c]an't [our franchisee] just pay you for the increase in your UI[338] premium? You know, [our franchisees] operate on a small profit margin. If they had to pay FICA[339] and that other stuff many of them would lose money."[340]

By franchising, the franchisor avoids unemployment insurance (UI), worker's comp, and the employer's portion of FICA (in the authors' experience, totaling about 13% to 16% of wages), while also avoiding paying fringe benefits (which the AAMCO franchisor once estimated at 15%[341]), for a total savings of roughly 30% over a traditional employee relationship. If the franchisee does not pay those costs, the resulting externalities are borne by other purchasers of labor (through higher UI and worker's comp premiums) and governments and hospitals which must provide care to those lacking "fringe" benefits such as basic medical insurance and a retirement pension. In addition, the franchisor can avoid the labor laws which would protect an employee, most notably the wage & hour laws. In the foodservice industry, the difficulty in getting legal labor has led to the hiring of large numbers of illegal immigrants.[342] Franchising can be an avenue for deriving revenue from an operation staffed by illegal (and underpaid) labor while at the same

338. UI is unemployment insurance. In this case, claims paid affected the employer's experience rating and affected the premium which was reset each calendar year.

339. FICA is the American old-age pension plan, referred to as Social Security. The specifics are beyond the scope of this paper, but note that if FICA contributions are not made, the worker will not be able to get a monthly check in retirement.

340. This particular franchisor tells franchisees that labor costs should equal 17% of gross. Assuming 7.5% FICA, 3% Worker's comp insurance, and 4% UI, claiming that statutory wages are the difference between profit and loss suggests a profit margin on the franchise of 2.47% (17 x 0.145). These numbers are indicative of just how unprofitable the franchise is for the franchisee. Implicit is the notion that profit is actually less where at least a few employees are paid in accordance with law.

341. McAlpine v. AAMCO Automatic Transmissions, Inc., 461 F. Supp. 1232, 1227 (E.D. Mich. 1978). The franchisor was seeking damages from franchisees who left AAMCO, for AAMCO's costs in reestablishing itself in the Detroit market. *See id.* Given that medical insurance has increased more rapidly than wage expense, the costs of fringe benefits today is likely much higher.

342. *Pending Immigration Reform Step Toward Helping Foodservice Solve its Labor Woes* (Editorial), NATION'S RESTAURANT NEWS, Aug. 13, 2001, at 29. *See also NCCR in Immigration Reform Push with Mexico*, NATION'S RESTAURANT NEWS, Aug. 20, 2001, at 3 (meeting with Mexican foreign secretary, to discuss worker shortage in service businesses).

time disclaiming legal responsibility.

Several franchisors employing low-wage workers at company outlets have recently paid large fines for violation of labor laws.[343] Corporate purchasers of labor are aware that the costs imposed by regulation are less by purchasing labor from a worker classified as a franchisee than as an employee. Additionally, opportunism *ex post* is less likely to attract the concern of regulators if it occurs in the franchisee relationship than in the employee relationship. Even one opponent of franchise regulation admitted: "[T]axpayers are much less likely to assent to paying large sums for fair franchising than they might for fair employment. The latter is a larger social problem that will likely directly touch the lives of many more voters."[344] Permitting purchasers of labor to take exploitative advantage of their superior bargaining power touches on the public interest; this is the essence of the *Lochner* debate. Moreover, because failure to impose economic costs for labor abuse in the franchise context makes it more attractive to purchase franchisee labor in lieu of employee labor, the social problem will grow.

As Professor Collins of Oxford noted, lack of protection for workers in non-traditional settings (such as franchisees) is a particular concern where those affected are in a socioeconomic status which makes it difficult for them to vindicate their rights.[345] Business ownership may be inversely related to socioeconomic status: in the U.S. blacks have a household net worth of $15,500 compared to $71,700 for all Americans,[346] but blacks are 50% more likely to try starting their own business.[347]

Although the etymology of "franchise" is from the Old French "franchir," to free from slavery,[348] in 1993 Congressman Kweisi Mfume described the situation of minority franchisees as the "old master-slave

343. Dina Berta, *Operators in Overdrive to Avoid Overtime Suits*, NATION'S RESTAURANT NEWS, Nov. 25, 2002, at 1 (companies such as Starbucks, Taco Bell, Pizza Hut, Einstein Bros. Bagels, Wendy's lost or settled suits). Settlements averaged $23,125 per worker at Wendy's and $2,903 at Taco Bell. *See* Alan J. Liddle, *Taco Bell Shells out $13M in OT Suit*, NATION'S RESTAURANT NEWS, Mar. 19, 2001, at 1, 123. Pizza Hut paid $10M to settle two class-action suits. *See* Alan J. Liddle, *Workers' Winning Claims for Back Overtime Shake Employers*, NATION'S RESTAURANT NEWS, Sept. 24, 2001 at 1. On legal requirements, *see generally*, David J. Comeaux, *Wage & Hour Update for the Hospitality Industry*, *in* HOSPITALITY LAW CONFERENCE (Jan. 24, 2003) (Conrad N. Hilton College of Hotel & Restaurant Management, Univ. of Houston).

344. O'Hara, *supra* note 96, at 1596.

345. Collins, *supra* note 314.

346. *Home Truths from the Barbershop*, THE ECONOMIST, Oct. 5, 2002, at 30 (citing a BET study released Aug. 2002).

347. *Id.* (citing Kauffman Foundation report released Sept. 24, 2002).

348. WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 727 (2nd ed. 1983).

relationship all over again."[349] In 1996, Burger King's president Robert Lowes and African-American franchisee La-Van Hawkins were feted at a White House ceremony attended by President Clinton and Vice-President Gore.[350] But by 2001 Hawkins left Burger King amid lawsuits alleging racism at Burger King and testimony from now ex-president Lowes that he had been unable to stop Burger King from impeding fulfillment of the agreement made with Hawkins.[351]

The next franchise industry poster boy was Calvin Johnson, the first African-American to open Athlete's Foot franchises in inner Washington, D.C. In 2001, Johnson was featured in the IFA newsletter as a minority entrepreneur who had "realize[d] the American dream" of operating a business.[352] By 2002, when Johnson decided to sell his failing store:

> [Athlete's Foot] brokered a deal, but I never heard back from their buyer. Ironically, when the time came to close down, my landlord offered to take $4,000 off of what I owed him in exchange for my benches and cash register. A few weeks later I walked by and saw the same guy (who was also the missing buyer) had opened up an Athlete's Foot in my old store. If the deal had gone through earlier, he would have had to pay me $45,000. I got zero out and he saved the $100,000 I paid to build the place out. He was even using my $10,000 sign.[353]

As has been discussed and will be further elaborated, franchisors today target immigrants just as the *Lochner* employers targeted immigrants. At least one franchisor negotiated a franchise sale with an immigrant who was in bankruptcy at the time and who borrowed the entire purchase price.[354] The franchisee testified that he opened for

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349. *Minority Franchising: Is Discrimination a Factor? Hearings Before the House Comm. On Small Business*, 103d Cong. 9 (1993).

350. Milford Prewitt, *Hawkins Departs BK Chain in Settlement After Court Defeats*, NATION'S RESTAURANT NEWS, Jan. 22, 2001, at 1, 49.

351. *Id.*

352. *Opportunities*, FRANCHISING WORKS (undated, ©2001) at 2 (on file with author).

353. Julie Bennett, *The Burning, Stinging Feeling of Athlete's Foot*, FRANCHISE TIMES, June/July 2002, at 16, 17.

354. Lee v. Hasty Market Inc., File No. 8536/84, 1993 A.C.W.S.J. LEXIS 49674 at *2-3 (Ont. Ct. of Justice 1993). The debtor's wife was the nominal franchisee, but the franchisor's founder had the sales discussions with the debtor, a Korean resident in Canada for 13 years. *Id.* at *2. The same franchisor also sold a franchise to a husband and wife who "had only two years experience in the business world and were largely uneducated" although possessed of "not only common sense but, also, good business sense." *See* Idriss Family Enterprises Ltd. v. Hasty Market Inc., 15614/86, 1991 A.C.W.S.J. LEXIS 36013 at *15-16 (Ont. Ct. of Justice 1991). The Idriss' testified that they worked from 7 a.m. to midnight. *Id.* at *10. The Idriss' borrowed half the purchase price and sold their home and business to raise the other half. *Id.* at *7.

business at 8 a.m. and closed at midnight,[355] hours longer than some of the *Lochner* bakers. Franchisors frequently mandate arbitration in distant fora, thereby rendering franchisee remedies economically unfeasible, a result which is not the case in most traditional employment relationships. Franchisor attorneys make many of the same legal arguments heard in the *Lochner* era.

In some respects, franchisees today are in an even more precarious position than the *Lochner* bakers, due to substantial sunk costs and the ability of franchisors to restrict franchisee revenue or even terminate the franchisee if the franchisee joins an association or testifies before Congress. Terminated franchisees may find themselves unable to earn a living in their chosen field due to non-compete covenants. The purpose of vertical disintegration is to confer an economic benefit upon the purchaser of labor. Many statutory restrictions attempt to deal with the ability of parties to externalize the effects of their behavior. By purchasing labor through a franchise business model, however, the franchisor is able to shift costs to the franchisee. In turn, many franchisees, already operating on narrow margins (or losses) are tempted to externalize costs as well. Externalities in such a case are more problematic because by the time of discovery, the franchisee may be out of business or lack the ability to compensate the social insurance scheme or private party which bears the cost by default.

Canadian courts have begun to recognize the vertical disintegration principle. In the case of Brian Head, a Radio Shack "joint venture manager" who worked for Radio Shack since graduating from high school, an Ontario court noted: "In the more complex conditions of modern industry, more complicated tests have to be applied."[356] When Radio Shack was the subject of a tax assessment appeal, it claimed that the store was under the control of Head, notwithstanding that Radio Shack was responsible for the property expenses.[357] By misleading the tax assessor, Radio Shack received more advantageous tax treatment.[358] Radio Shack also benefited from classifying Head as independent to avoid the notice provisions of the Employment Standards Act.[359] The court found that the plaintiff "had little influence as a franchisee. He certainly was much like a company store manager who was on a

355. *Lee*, 1993 A.C.W.S.J. LEXIS at *4.

356. Head v. Inter Tan Can. Ltd., [1991] 5 O.R.3d 192, 214 (citing Montreal v. Montreal Locomotive Works Ltd., [1947] 1 D.L.R. 161, 169). Brian Head joined Radio Shack as a high school graduate and worked for Radio Shack as an employee, and later as a "joint venture" partner for 13 years before termination. *Id.* at 195.

357. *Head*, 5 O.R.3d 197.

358. *Id.*

359. *See id.* at 197.

somewhat different profit sharing arrangement."[360] The indicia of employee status led the court to agree that Radio Shack had the same right to terminate as if the individual were a regular store manager.[361]

In a Nova Scotia case, Imperial Oil had Esso gas outlets across Canada run by a wholly-owned subsidiary, Atlas Supply. When an Atlas site in Nova Scotia experienced a sharp decline in sales and increasing competition from Canadian Tire franchisees, Atlas decided to franchise the site[362] to a man who had a high school equivalency diploma and extensive business experience.[363] Atlas estimates of profits ranged from $11,000 (franchisor projection not disclosed to franchisee) to $33,000 (the projection disclosed to franchisee).[364] The franchisee testified that he believed the $33,000 figure because it came from a representative of Esso.[365] On cross-examination, the franchisor salesman admitted that the projections were based on the franchisee working for free:

Q: In fact, in any of these documents that we see were provided by Atlas, we do not see the state of the assumption that the owner is expected to donate his time for nothing, do we?

A: That is correct.

Q: Nor was that discussed with [the franchisee], that he was expected to donate his time for nothing, correct?

A: Mr. Murphy was aware that the franchise program was designed for the franchisee to assume full time responsibility at the franchise location.

Q: Oh no doubt about that, since he's the owner, but there's a great deal of difference between him being one of the employees and him being the owner isn't there?

A: Yes.

Q: . . . I believe you knew in your own mind that it took at least three people to run the franchise operation in Yarmouth, not two. But you say your assumption was he was expected to be the third of them?

A: I believe that he was aware of that as well.

Q: Oh, did you tell him that?

A: I think we discussed it yes.

Q: In your discovery, however, you haven't mentioned anything

360. *Id.* at 210.

361. *See id.* at 212-14. The Court noted the Operations Manual, purchase requirements, franchisor ownership of the premises, franchisor inspections, and need for the franchisee to work long hours which precluded any other business. *Id.*

362. Atlas Supply Co. of Canada Ltd. v. Yarmouth Equipment Ltd., [1991] 103 N.S.R.2d 1,3.

363. *See id.* at 4.

364. *See id.* at 5-6.

365. *See id.* at 6 (quoting from trial transcript page 387).

about that discussion have you, even after I asked you to relate all of your discussions with [the franchisee]? You don't recall ever having said that before, do you?

A: I guess this is the first time.[366]

The franchisor admitted that franchisee profit potential "was marginal, $33,000 for the investment plus the effort and responsibility, it was a marginal type operation."[367] Franchisors pitch their product using the N.Y. Attorney General's approach to sell the "American dream," and talk about franchising as a "fabulous opportunity:"[368] "When owning a franchise, you are in business for yourself, but not by yourself . . . Enjoy your American Dream."[369] Franchisors don't disclose the true nature of the relationship and the monetary realities. One of the authors attended a CLE seminar "Fundamentals of Franchising" where a franchisor attorney admitted that her clients did not make an Item 19 (Earnings Claims) disclosure since "why would a mid-level executive at Texaco want to quit his job to make 35K as a franchisee?" Additionally, a former Subway salesman noted that buying a single unit meant "you bought yourself a middle-paying job."[370] One husband-and-wife team operating two franchised units reported $45,000 annual income after 10 years of 70-hour weeks.[371] Most American franchisees are single unit owners. FRAN data reports that of 271,431 franchisees, only 30,000 are multi-unit owners (many of the multi-unit owners are large corporations).[372]

One hapless McDonald's franchisee in Australia did not even make minimum wage. Worse, after working for a year at McDonalds, he was denied a franchise on the basis of harassment allegations and he brought suit against the franchisor.[373] The court trying his case, in *dicta*, found that the allegations "have not been proved, and in a number of respects they have been revealed as untruthful."[374] The court then turned to the McDonald's claim:

Counsel for McDonald's submits that it accepted no contractual

366. *Id.*

367. *Id.* at 5.

368. Kaufmann, *supra* note 22 (quoting Eric Dinallo, N.Y. Attorney General's office).

369. *Franchising 101*, *available at* http://www.carwashguys.com/franchise101.shtml.

370. Behar, *supra* note 46, at 128.

371. *Id.* at 132. Recently per-store sales, and presumably, profitability, are much higher in the wake of a successful ad campaign stressing the health benefits of the product.

372. Julie Bennett, *Turn-ons and Turn-offs of Multi-unit Franchisees*, FRANCHISE TIMES, Sept. 2003, at 10.

373. Carr v. McDonald's Australia Ltd., 1994 AUST FEDCT LEXIS 1058.

374. *Id.* at *82.

> obligation when it induced Mr. Carr to set aside six days a week for a year, without receiving any kind of wage, to engage in a mix of studies and work, part of which was done on behalf of McDonald's itself, and all of which was directed by McDonald's, presumably with a view to its commercial purposes, and was intended to lead to a grant of a franchise by it to him. It seems to me that, in the circumstances of this case, the submission only needs to be stated to be rejected.[375]

The Australian court ruled in favor of Mr. Carr, so he fared better than the New Yorkers who worked for McDonalds. As welfare recipients, New York workers were forced to work without pay at a McDonald's outlet alongside paid workers, without even the prospect of a minimum-wage paycheck, let alone a franchise.[376]

Foreigners in the United States are particularly vulnerable. In Boston, the Finagle a Bagel chain brought a group of management applicants from Sri Lanka for an 18-month "training," and the trainees alleged that they were forced to work 75 hours per week, not paid the minimum wage, and fired when they complained.[377] The exernalities created by abuse of labor by franchisors occur in both company-owned and franchised outlets, and both in the United States and abroad. McDonald's shuttered a Canadian outlet (on which it continued to pay $17,000 per year in real estate tax) when the workers scheduled a union vote and when the message didn't get through McDonald's closed a second location in downtown Montreal, reportedly with 4 years of rent payments remaining, to prove the point.[378] For reasons grounded in economics as well as social policy, franchisors should be held to a standard of commercial morality, and the most certain and predictable means of imposing such standards is legislatively. Absent legislation, courts will often use the equitable principle of good faith.

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375. *Id.* at *25-26. The court noted the franchisee worked "[J]ust as Jacob, to secure the hand of Rachel, worked for Laban for the seven years, that 'seemed unto him but a few days.'" *Id.* at *19. Some former franchisees have put McDonald's training to use elsewhere. One of the largest pornographic movie companies was founded by a (McDonald's) Hamburger U. grad who said "I learned about inventory, buying the proper insurance, doing everything by the book, not taking shortcuts." Frank Rich, *Naked Capitalists*, N.Y. TIMES MAG., May 20, 2001, at 51, 53.

376. Frankie Edozien, *City Served Tasty Treat to McD's: Free Labor*, N.Y. POST, Sept 22, 2002, at 8.

377. *Visa Holders Sue Bagel Chain over Training Flap*, NATION'S RESTAURANT NEWS, Sept. 8, 2003, at 3. The franchisor denied the charges in the lawsuit. *Id.*

378. *McDonald's Orchestre la Non-Rentabilité de ses Restos Syndiqués, Selon la CSN*, LA PRESSE CANADIENNE, July 12, 2001, *available at* 2001 WL 24687457.

III. Post-Sale Relationship Issues

A. Sourcing Requirements: Fiduciary & Antitrust Issues

Franchisees are generally not on equal footing with franchisors, although told that they will be partners with the franchisor. Under those conditions, it is not unreasonable to hold franchisors to the fiduciary duties which they assume by virtue of their partnership representation. The Supreme Court of Canada established a three-pronged standard for finding the existence of a fiduciary relationship: (1) exercise of discretionary power (2) that can be exercised unilaterally so as to effect the beneficiary's legal or practical interests; and (3) "a peculiarly [sic] vulnerability to the exercise of that discretion or power."[379] A broader definition is enunciated by an American regulator: "[a] fiduciary relationship arises when one person is under a duty to give advice for the benefit of another on matters within the scope of their relationship and the advisor occupies a dominant position over the other."[380] Franchisors would contend that the franchisor is not giving the franchisee advice for the benefit of the franchisee but rather giving orders for the benefit of the franchisor, and that a properly drafted franchise agreement reflects this cold reality. This is why franchisors claim to be "partners" with their franchisees when advertising and when lobbying Congress, but not before a court of law.

Although good faith exists in both fiduciary and non-fiduciary relationships, both the meaning of good faith and the burden of proof differ. As one who has control of assets belonging to a second party, the fiduciary must act with "utmost good faith,"[381] fiduciary duty being "the highest standard of duty implied by law."[382] Although prospective franchisees may think that the franchise relationship imposes fiduciary obligations on the franchisor, even if the franchisee does not express that in such legal terms,[383] courts have generally held that "a franchisor/franchisee relationship is not fiduciary or confidential in nature."[384] Yet, an American court stated that a fiduciary relationship

379. Ontario Ltd. v. Bulk Barn Foods Ltd, [1999] Ont. Sup. C.J. LEXIS 789, at *15, (citing LAC Minerals Ltd. v. International Corona Resources Ltd., [1989] 2 S.C.R. 574, 577-78).

380. In re Lazard Freres & Co. LLC, Securities act of 1933 Release No. 33-7671, Securities Exchange Act of 1934 Release No. 33-41318 (Apr. 21, 1999) (applying New Jersey law).

381. BLACK'S LAW DICTIONARY 410 (6th ed, 1990).

382. *Id.*

383. PURVIN, *supra* note 195, at 191-92.

384. Layton v. AAMCO Transmissions, Inc., 717 F. Supp. 368, 371 (D. Md. 1989). *Accord* Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480, 485 (5th Cir.

could be found where the franchisor "has a duty independent of the contract to act for the franchisee's benefit."[385]

The proposed SBFA set forth certain instances in which the franchise relationship would be a fiduciary relationship.[386] The record shows that many franchisees are unsophisticated parties. Even a pro-franchisor commentator noted that since such parties may not distinguish "fair" from "unfair," franchisors' fiduciary standards would protect unsophisticated purchasers and also benefit those franchisors which already treat their franchisees fairly.[387]

A Canadian judge noted the *Jirna v. Mr. Donut*[388] holding that the franchise relationship was not fiduciary, but also took note of the Arthur Wishart Act's imposition of a duty of fair dealing in every franchise agreement:

> [I]t is evident to me that the relationship between a franchisor and franchisee is something more than a pure commercial relationship between arm's length parties who can look only to their own selves for the protection of their respective interests. I tend to agree with counsel for the plaintiff that the franchisor/franchisee relationship is more akin to that of a partnership. It is certainly, in my view, a relationship to which the duty of utmost good faith should apply in terms of the dealings between the franchisor and the franchisees.[389]

Failure to see the franchisor as a fiduciary has significant economic effect on the franchisee. "Rebates" are a common practice in the foodservice industry,[390] and can amount to millions of dollars for a single

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1984); Barnes v. Burger King Corp., 932 F. Supp. 1420, 1430 (S.D. Fla. 1996); Burger King v. Austin, 805 F. Supp. 1007, 1020-21 (S.D. Fla. 1992); Dr. Pepper Bottling Co. of Tex. v. Del Monte Corp., No. 18748 1990 U.S. Dist. LEXIS, at *15 (N.D. Tex. 1990) (applying California law); Picture Lake Campground v. Holiday Inns, Inc., 497 F. Supp. 858, 869 (E.D. Va. 1980). *See also* Country Style Food Services Inc. v. Roupen Hotoyan, [2001] Ont. Sup. C.J. LEXIS 1581, at *26, citing Jirna Ltd. v. Mr. Donut of Canada Ltd., 22 D.L.R. 3d 639, 647 (1971) (applying Canadian law). *Contra* Arnott v. The American Oil Company (Amoco), 609 F.2d 873, 881-84 (8th Cir. 1979) (noting "further indication of the fiduciary nature of a franchise relationship is found in the recent surge of general franchise legislation," finding fiduciary duty under South Dakota law, but noting state law split).

385. Norwood v. Atlantic Richfield Co., 814 F. Supp. 1459, 1468 (D. Ore. 1991).

386. *See* H.R. 3308, 106th Cong. § 5(c) (1999).

387. George W. Dent, Jr., *Gap Fillers & Fiduciary Duties in Strategic Alliances*, 57 BUS. LAW. 55, 78 (2001).

388. Jirna Ltd. v. Mister Donut of Canada Ltd., [1979] 40 D.L.R.3d 303, *aff'g* 22 D.L.R.3d 639, *rev'g* 13 D.L.R.3d 645.

389. Shelanu Inc. v. Print Three Franchising Corp., [2000] Ont. Sup. C.J. LEXIS 2369 at *19, citing Perfect Portions Holding Co. v. New Futures Ltd., [1995] O.J. No. 2113 (Gen. Div.) at para. 14. The *Shelanu* court stated that it would have found a duty of good faith even absent the Wishart Act. *Shelanu*, 2000 Ont. Sup. C.J. at *20-21.

390. Mark Smith, *Many Happy Returns: Automated Contract Management can Pay*

franchisor. The first franchise case in Canadian history, *Jirna v. Mr. Donut*, involved secret rebates that the franchisor was receiving on products it required the franchisees to purchase, and also involved the degree to which a franchisor was or was not a fiduciary of the franchisee.[391] Franchisees may maintain that the franchisor is a Purchasing Agent of the franchisee, and hence in a fiduciary relationship, therefore prohibiting super-competitive pricing by direct or indirect means.[392]

Tying is "an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier."[393] In order to maintain quality standards, franchisors customarily require the purchase of raw materials from an authorized supplier. In some cases, the franchisor simply specifies the supplier and collects a "rebate" directly from the supplier, which the franchisor is able to do because of its power over its franchisees.[394] In other cases, a franchisor subsidiary which is designated as the franchisee supplier buys the supplies and then resells them to the franchisees at a markup. The Franchise Rule provides for disclosure of "any revenue or other consideration to be received by the franchisor or persons affiliated with the franchisor,"[395] but the "affiliated persons" are narrowly defined, and the *Interpretive Guides* to the Rule begin by noting that "[d]isclosure is limited to situations in which . . ."[396] indicating the narrow nature of the disclosure qualifications.

Many franchisees do not inquire into sourcing requirements and "rebates" until there is a crisis which causes examination of the contracts. In the McDonald's system, in the wake of the rigged sweepstakes scandal, it was alleged that franchisees were not even allowed to ask about the ownership of vendors mandated for purchase of paper goods

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Off with Top Rebates, NATION'S RESTAURANT NEWS, June 30, 2003, at 34 ("from an operator's perspective, the ultimate price of an item is its landed cost less the rebate").

391. Jirna Ltd. v. Mister Donut of Canada Ltd., [1970] 13 D.L.R.3d 645, *rev'd* 22 D.L.R.3d 639, *aff'd* 40 D.L.R.3d 303.

392. Ontario Ltd. v. Bulk Barn Foods Ltd., [2000] Ont. Sup. C.J. LEXIS 1945 at *5.

393. Northern Pacific Railway v. U.S., 356 U.S. 1, 5-6 (1959). Note that the FTC may act against such arrangements under 15 U.S.C. § 45(a)(1) (1994). More commonly, action is taken pursuant to the Sherman Act, or Clayton Act, 15 U.S.C. §§ 1, 2, 14 (1994).

394. *Cf.* FTC v. Texaco, Inc., 393 U.S. 223, 224 (1968). The maker of 7-Up alleged that PepsiCo, former owner of the brands spun-off as Tricon, violated antitrust laws causing the number of Tricon restaurants carrying 7-Up to fall from 5,000 to 2,000 in less than 2 years. *Lawsuit Alleges PepsiCo Antitrust Violations*, NATION'S RESTAURANT NEWS, Oct. 15, 2001, at 48.

395. Franchise Rule § 436.1(a)(11) and Interpretive Guides, *available at* BFG ¶ 6244.

396. *Id.*

("Perseco") and technology ("E-Mac Digital").[397] The Jack in the Box burger chain suffered a fatal food poisoning outbreak in 1993 and a resultant decline in sales triggered examination of vendor "rebates" to the franchisor. By 1996, franchisees uncovered Coca Cola rebates and filed suit against the franchisor. The resultant decline in the relationship, according to franchisees, led to the franchisor's failure to attend the franchisee's 2002 convention.[398]

Photovest Corporation v. Fotomat Corporation, one of the earliest U.S. franchise cases involved the Fotomat photo processing franchisor, which obtained hidden rebates ranging from 2% to 10%,[399] even as it promised franchisees that the franchisor's "buying power" would be "passed along" to franchisees.[400] The amounts involved can be huge. *Queen City Pizza* involved the Domino's franchisor, which sold almost half a *billion* dollars per year[401] to franchisees at markups that the franchisees alleged were up to 40% above the free market price and cost $3,000 to $10,000 per year per store above the free market price.[402] Although *Queen City* was sanguine about the large markups, in *Photovest* the franchisor's ability to charge large markups was seen as indicative of the presence of a submarket.[403] An excellent primer on the topic is *Regents v. Subaru*,[404] in which the court held that while a single brand parts market could be established, a "market" must evidence cross-elasticity of supply and cross-elasticity of demand. Although the court applied Australian law, it discussed the economic underpinnings of the concept and foreign cases, including *Kodak*. *Regents* is a persuasive and cogent intellectual argument against the applicability of market power theory in franchise cases, and the court ruled against the franchisee, but the practical issue of franchisor hold-up remains.

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397. Letter from Richard Adams, Franchise Equity Group, to Editor, NATION'S RESTAURANT NEWS, Oct. 15, 2001, at 21.

398. John Hamburger, *Jack in the Box Franchisees Meet in Hawaii*, FRANCHISE TIMES, Jan. 2002, at 8. The franchisor stated that a general belief that there would be sparse franchisee attendance as well as "scheduling conflicts on the part of our executive management" were the reasons for nonattendance. *Id.*

399. Photovest Corp. v. Fotomat Corp., 1977 U.S. Dist. LEXIS 15832, at *69 (S.D. Ind. 1977). As is evident in the Fotomat case, rebates are often hidden even from franchisor employees. This author is aware of one franchisor employee who discovered vendor invoices showing a 1% discount. When the employee asked what became of the 1%, the invoices were quickly taken away, and when the employee was given copies a few weeks later, the 1% was no longer disclosed.

400. *Id.* at *35.

401. Queen City Pizza, Inc. v. Domino's Pizza, 124 F.3d 430, 433 (3rd Cir. 1997) ("worth $450 million per year, form[ing] a significant part of Domino's Pizza, Inc.'s profits").

402. *Id.* at 434.

403. Photovest Corp. v. Fotomat Corp., 606 F.2d 704, 713 (7th Cir. 1979).

404. Regents Pty. Ltd. v. Subaru (Aust.) Pty. Ltd., [1998] 84 FCR 218.

Antitrust arguments may be tenuous, but conceptually, the fiduciary argument is persuasive. Unfortunately, courts have been reluctant to find a fiduciary relationship, despite the nature of the franchise relationship. In *Bulk Barn Foods*, the franchisor purchased materials and then resold them to franchisees.[405] The court held there was no third party, hence, no fiduciary relationship when the franchisor purchased from the suppliers, and the franchisor "in no way [bound] franchisees to that purchase,"[406] as the relationship "was one of vendor-purchaser."[407] The court cited a Nova Scotia distributorship case[408] and reasoned that since the franchisor (agent) did not bind the franchisee (principal), there was no fiduciary duty.

The reality is that the franchisee *must* purchase the product at whatever price the franchisor demands in order to purchase or retain the franchise. In other words, one product, the franchise, is tied to a second product, aftermarket supplies.[409] To assert that this is disclosed to the prospective purchaser ignores the ability of the franchisor to take advantage of franchisee sunk costs by means of ex post alterations to sourcing requirements. For example, the retail gasoline market is highly competitive and every penny makes a difference. In *Wilson v. Amerada Hess Corporation*, a jury awarded $2.6 million to the franchisees who alleged that the petroleum franchisor had charged supracompetitive prices in order to drive the franchisees out of business and capture the sites for company-owned outlets.[410] Also, the 7-Eleven franchisor has "total control of the gasoline" purchases, and franchisees report that they lose business to competitors who get a lower wholesale price.[411] Ironically, the only reported case of a franchisee overbilling the franchisor and getting a vendor kickback is a 7-Eleven case.[412]

In *Eastman Kodak Company. v. Image Technical Services*[413] the United States Supreme Court found that tying the aftermarket purchase of supplies to the initial purchase of a xerographic copier could give rise to an antitrust claim. Although *Kodak* is a controversial decision,[414] the

405. Ontario Ltd. v. Bulk Barn Foods Ltd., [2000] Ont. Sup. C.J. LEXIS 1945 at *6.
406. *Id.* at *7.
407. *Id.* at *8.
408. *Id.*, citing Scott v. Trophy Foods Inc., [1995] 123 D.L.R. 4th 509.
409. *See* Warren S. Grimes, *GTE Sylvania and the Future of Vertical Restraints Law*, ANTITRUST, Fall 2002, at 27, 29 (noting potential for exploitation by franchisor, as well as franchisee difficulty with Sherman Act Section 1 claims for vertical price maintenance and tying).
410. *See* Nora Lockwood Tooher, *Hess Oil Company Slammed For Overcharging Gas Stations*, LAWYER'S WEEKLY USA, July 21, 2003, at 22 (discussing the case).
411. Sparks, *supra* note 282.
412. Hksar v. Yip Yiu Wing, [2001] HKEC 123 (Criminal Court, Hong Kong).
413. 504 U.S. 451 (1992).
414. *See* Benjamin Klein, *The Law of Vertical Restraints in Franchise Cases and*

Kodak analysis is on point in the franchise context, as Professor Grimes observed:

> [I]n some franchising relationships, the franchisor has power over franchisees that, because of non-recoverable or sunk investments, are locked into the franchise relationship. Franchisees can be exploited by a relatively powerful franchisor in a number of ways, including the setting of low maximum resale prices or tie-ins that force the franchisee to pay supracompetitive prices for the tied product.[415]

The ability of a franchisor to charge supracompetitive markups, particularly on materials it merely buys on the open market and resells to captive franchisees, should be *prima facie* evidence of a unique submarket. Even the franchisor trade association, the IFA, tells prospective franchisees that "[r]estrictions on the suppliers from which franchisees may buy goods and services used in the establishment and operation of their business is comprehensively regulated under federal and state antitrust and trade regulation laws."[416]

In court, franchisors sing a different tune. In analyzing the post-*Kodak* world, one attorney observed that while "*Kodak* rescued franchise tying claims from the dustbin of history . . . it is unlikely to yield a harvest of franchise victories on the merits,"[417] a view which is borne out by recent court decisions[418] that revert back to the pre-*Kodak* "incident of the contract" argument for franchisor exemption from antitrust laws in supply sourcing. Such holdings mean that discretionary post-sale franchisor sourcing requirements are *not* "comprehensively regulated" under antitrust laws, unless the franchisor has an incredibly incompetent

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Summary Adjudication: Market Power in Franchise Cases in the Wake of Kodak: Applying Post-Contract Hold-up Analysis to Vertical Relationships, 67 ANTITRUST L.J. 283 (1999). The Kodak result has been hotly debated by Benjamin Klein and Warren Grimes. *See id.* at 284. Antitrust law is strongly linked to prevailing political winds. Klein's view that post-contract "hold-up" of franchisees is not an antitrust problem, but rather a "contract problem" had some success prior to *Kodak*. *See* Tominaga v. Shepherd, 682 F. Supp. 1489, 1494-95 (C.D. Cal. 1988). *Kodak* presents a difficult precedent for franchisors, who would maintain the "contract problem" argument today. *But see* Queen City Pizza, Inc. v. Domino's Pizza, 124 F.3d 430, 435 (3rd Cir. 1997). *See also* Ajir v. Exxon Corp., 1999 U.S. App. LEXIS 11046 at *16-17 (9th Cir. 1999) (court fails to mention *Kodak* but cites a pre-*Kodak* 9th Circuit decision in finding that the franchisor did not possess market power since the franchisee could "surrender one franchise and acquire another" and the franchisor power is not relevant to a tying analysis since "this power is related to the franchise method of doing business").

415. Grimes, *supra* note 409, at 29.

416. International Franchise Association Code of Principles and Standards of Conduct § V.8 ("Supply Sources") *available in* FRANCHISE OPPORTUNITIES GUIDE 17, 20 (Fall/Winter 2000).

417. Allan P. Hillman, *Franchise Tying Claims: Revolution or Just a "Kodak Moment?,"* FRANCHISE L.J., Summer 2001, at 1, 46.

418. *Id.* at 39 ("The Post-*Kodak* Scorecard").

attorney drafting the franchise agreement. If the position taken by the IFA in its Code of Principles is to mean anything, then the Supreme Court holding in *Kodak* must trump the Third Circuit holding in *Queen City*. More importantly, if binding authority in the common law is to mean anything, *Kodak* must trump *Queen City*. Some courts have avoided application of *Kodak* by stating that if the corporation does not have market power in the tying product, and announces in advance that there is a tied product, there can be no tying claim;[419] this is the old "incident of the contract" argument.

Allowing the exemption of franchisors from the antitrust laws because the post-contractual holdup is an incident of the franchise relationship is predicated on a belief that the prospective purchasers are able to quantify the economic rapacity of a franchisor possessing contractual discretion. Markets are imperfect, which "can create sufficient market power to justify possible antitrust liability[,]"[420] this is the lesson of *Kodak*.

Contrary to the notions of the New York Attorney General, this is another example of the differences between the franchise marketplace and the securities marketplace. While it is true that the securities marketplace is exempt from much antitrust law,[421] and *Queen City* opined that a similar result should occur in the franchise marketplace,[422] *Queen City* is wrong. The securities marketplace exemption is based on the doctrine of implied repeal of the Sherman Act resulting from Congressional passage of the Securities and Exchange Act of 1934.[423] The 1934 Act regulates the period after the issuance of shares by a public company. There is no analogous federal regulation of franchises. The closest equivalence is between the Securities Act of 1933[424] and the Franchise Rule,[425] a regulation promulgated by an agency. Because there is no preemptive statute, post-contractual holdups cabined only by franchisor discretion are not impliedly preempted with respect to antitrust claims. Even in cases applying implied preemption, exemption from antitrust laws is only allowed to the extent necessary to implement

419. Metzler v. Bear Automotive Serv. Equip. Co., 19 F. Supp. 2d 1345, 1364-65 (S.D. Fla. 1998).

420. Queen City Pizza, Inc. v. Domino's Pizza, Inc., 124 F.3d 430, 447 n.4. (3rd Cir. 1997) (Lay, J., dissenting).

421. Neal R. Stoll & Shepard Goldfein, *Securities Laws Trump Antitrust Laws Again*, N.Y.L.J., Feb. 18, 2003 at 3.

422. Queen City Pizza, Inc. v. Domino's Pizza, Inc., 124 F.3d 430, 441. (3rd Cir. 1997).

423. Stoll & Goldfein, *supra* note 421 (the 1934 Act is codified at 15 U.S.C. § 78).

424. 15 U.S.C. § 78.

425. 16 C.F.R. § 436 (1979). The Franchise Rule may be accorded deference. *See* Chevron U.S.A., Inc. v. Natural Resources Defense Council Inc., 467 U.S. 837 (1984). But implied preemption would violate the Constitution.

the law passed by Congress.[426] Unconstrained by principles of antitrust or agency, franchisors are free to take opportunistic advantage of franchisees, and there is no way for the franchisee *ex ante* to make an informed decision. As the *Queen City* dissent noted, "it would be illogical for the franchisees to expect that the franchisor's [discretionary contract right] coupled with its approval power in the franchise agreement, included for the very legitimate purpose of franchise quality control, would be applied in such an odd and predatory [manner]."[427] Indeed, a franchisor may require substitution of an inferior product at an above-market price, and require purchase quantities in amounts which cause spoilage and waste.[428] Although there are numerous examples of franchisor opportunism, given the debate over the existence of a tying relationship[429] and the franchisor representations of partnership; constraining sourcing opportunism would be most easily accomplished by a legislatively-crafted fiduciary standard. This would also avoid the economic and political shifts which create employment for hordes of antitrust lawyers.

B. Encroachment

No issue in franchising is more contentious than encroachment, and no issue better illustrates the difficulties in regulating the franchise relationship. Encroachment occurs where a franchisor establishes a second outlet that takes profits[430] that would otherwise belong to the existing (first) outlet.[431] Encroachment may occur by means of a new "bricks and mortar" location, a "virtual" location,[432] a new distribution

426. Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963).

427. Queen City Pizza, Inc. v. Domino's Pizza Inc., 124 F.3d 430, 448-49 (3rd Cir. 1997) (Lay, J., dissenting).

428. A&K Lick-a-Chick Franchises Ltd. v. Cordiv Enterprises Ltd., [1981] 56 C.P.R.2d 1 at ¶ 17 (noting that spices were 2½ times more cost, and chicken packaging of franchisor-supplied products were inferior to outside sources).

429. *See*, Warren S. Grimes, *When Do Franchisors Have Market Power? Antitrust Remedies for Franchisor Opportunism*, 65 ANTITRUST L.J. 105, 141 (1996).

430. Carvel Corporation required franchisees to pay royalties on 10,000 gallons/year even though the average use per store declined from 7,330 gals in 1987 to 6,120 gals in 1992. *See* Carvel Corp. v. Baker, 79 F. Supp. 2d 53, 56-57 (D. Conn. 1997). Not only was the true royalty 40% higher than quoted, the franchisor actually benefited from franchisee losses since it obtained the same royalty for selling less product and suffered no loss by establishing a second distribution outlet of supermarkets to compete with franchisees. *See id.*

431. Defining encroachment is more art than science, but this definition takes into account not merely a present decline in sales but a permanent diminution in sales growth. By looking at lost profits rather than lost sales, one can account for the erosion of marginal profit rate (the percentage of profit on the last dollar of gross sales).

432. Emporium Drug Mart, Inc. of Shreveport v. Drug Emporium Inc., BUS. FRANCHISE GUIDE (CCH) ¶ 11,966 (Amer. Arb. Assn., Dallas, Tx., filed Sept. 2, 2000)

channel, such as a supermarket,[433] within the territory, or franchisor capture of a franchisee's customer, pre-sale,[434] or post-sale. Encroachment may be a result of action by a franchisor both deliberate,[435] or inadvertent[436], or a merger between franchises,[437] or encroachment by one franchisee selling into another franchisee's territory,[438] or by a shrinkage of the product's market due to population shifts or reduction in demand for the product itself.[439] In some cases, a franchisor may even establish a second franchise under a different name to compete head-on with its existing franchisees.[440]

A more recent issue has been "co-branding." For example, Taco Bell, KFC, and Pizza Hut are owned by the franchisor Tricon, which has

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(internet site advertised as "virtual drugstore").

433. Both Häagen-Dasz, and Carvel have practiced this form of encroachment. *See* Carvel Corp. v. Baker, 79 F. Supp. 2d 53 (D.Conn. 1997).

434. This author was informed by a franchisee of high-ticket dry goods, and that a customer inquiry to a franchisor's toll-free line resulted in the customer being instructed to view the product at a local (franchised) location and then call back the toll-free line or order online at the (franchisor) website to get a better price.

435. *See* Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., 139 F.3d 1396, 1401 (11th Cir. 1998) (Sheraton purchased Hyatt location & converted to company-owned). Encroachment may be punitive, retaliating for a franchisee's criticism of a franchisor or attempting to form a franchisee association, or to upgrade or open new outlets, or otherwise failing to accede to franchisor wishes.

436. This may occur where the franchisor provides Internet ordering and a customer does not enter the location of the local franchise showroom where he viewed the product.

437. *Cf.* St. Charles Foods, Inc. v. Am.'s Favorite Chicken Co., 198 F.3d 815, 817 (11th Cir., 1999) (Popeye's acquired Church's Chicken). The issue was franchisee right of first refusal for new outlets of the formerly competing chain, where both chains retained separate names under same franchisor parent. *Id.*

438. *Cf.* Bronx Auto Mall, Inc. v. Am. Honda Motor Co., Inc., 934 F. Supp. 596 (S.D.N.Y. 1996). Honda arbitrarily set a figure of 600 Acura dealers, resulting in dealers in unsuitable markets. *Id.* at 598. The Bronx dealer had to compete on price to lure customers from the suburban dealers' trade area. *Id.* at 602. Nationwide, the number of Acura dealers losing money rose to 60% by 1993 before falling back to 40-50%. *Id.* at 601.

439. A franchisor attorney remarked that one of the problems with Carvel was that cultural shifts meant that parents were not taking their children out to ice cream parlors anymore, but were buying supermarket ice cream instead; the Carvel franchisor had to establish a supermarket presence as a matter of brand survival. David J. Kaufmann, remarks at *Understanding Franchising: Business & Legal Issues* (Practising Law Institute seminar June 12, 2001). The burger franchises (McDonald's, Wendy's & Burger King) saw rapid expansion push retail prices down, David Leonhardt, *A Sinking Feeling At the Register: Lower Prices are Disrupting Many Industries*, N.Y. TIMES, Jan. 19, 2003 at BU1, BU10 (33% increase in outlets from 1994-2001), at the same time that consumer tastes changed, Lenore Skenazy, *Golden Arches Are Falling*, N.Y. DAILY NEWS, Jan. 19, 2003 at 41 ("McDonald's still treats us like kids . . . the classic, clueless 1950's parent"). And that may be a permanent shift. Shirley Leung, *Fleeing From Fast Food*, WALL ST. J., Nov. 11, 2002, at B1 (young consumers are seeking healthier foods; franchisors are forced to diversify brands to meet changing tastes).

440. Shelanu Inc. v. Print Three Franchising Corp., [2000] Ont. Sup. C.J. LEXIS 2369 at *27-28.

now begun selling pizzas in the taco and chicken outlets.[441] Co-branding can create a ubiquity which dilutes the value of the brand to the franchisee, while creating additional royalty revenue for the franchisor.[442] Co-branding may result in both encroachment to the neighboring franchisees and lower profits and longer work hours to the franchisee pressured to co-brand.

Franchisors commonly argue that they would never do anything, such as encroachment, which would harm the profitability of their franchisees, since their interests are aligned. The evidence shows otherwise. Recently Yum Brands (KFC, Taco Bell, Pizza Hut) disclosed that margins of co-branded units were actually below those of single brand units.[443] An editorial in an industry paper noted that an Allied Domecq (Dunkin' Donuts, Baskin Robbins, Togo's) franchisee claimed that a Dunkin' lawsuit ostensibly for sanitary failure was actually punishment for the franchisee's failure to assent to co-branding. The editorial continued:

> Such suspicions . . . are hardly surprising given that franchisors . . . stand to gain more royalties and initial fees when franchisees deploy more than one of their concepts. If multibranding doesn't always translate into higher margins, as Yum has indicated, it is not surprising that some franchisees might question the motives of franchisors pushing the development of multiconcept stores.[444]

Threats of encroachment may be used to obtain franchisee acquiescence to franchisor demands. A chicken franchisor seeking franchisee assent to a rewritten franchise agreement "did exert pressure upon the [franchisee] defendants by threatening to construct a competing outlet across the street."[445] In systems such as Domino's Pizza where franchisor buy-out price is set as a multiple of cash flow, encroachment may be used "to lower the cash flow of the units [that] may be coveted by the franchisor or owned by a 'troublesome' franchisee."[446] Once

441. Amy Zuber, *To Market, to Market: Chains Find Strength in Numbers, use Co-branding as Growth Vehicle*, NATION'S RESTAURANT NEWS, Feb. 5, 2001, at 45, 46. *See also* Prewitt, *supra* note 20, at 46 (franchisee attorney J. Michael Dady noting "new era" of encroachment thru multibranded outlets, Internet, and supermarket distribution).

442. Ellen Shubart, *When Franchises Become a Candy Bar*, FRANCHISE TIMES, Feb. 2000, at 47.

443. Editorial, *Blissful Union? Long-term Benefits of Co-branding Remain to be Seen*, NATION'S RESTAURANT NEWS, Aug. 4, 2003, at 27 (also noting Arby's franchisor abandoning co-branding due to difficulties with the concept).

444. *Id.* at 30.

445. A&K Lick-a-Chick Franchises Ltd. v. Cordiv Enter. Ltd., [1981] 56 C.P.R.2d 1, 1981 C.P.R. LEXIS 409 at *5.

446. Letter from John Rachide, Chairman of the (Domino's Pizza) International Franchisee Advisory Council, to Federal Trade Comm'n. (Apr. 30, 1997) *available at*

again, we see that the franchise marketplace is not like the securities marketplace: in an analogous securities market transaction where "a majority stockholder wishes to involuntarily squeeze-out the minority, it must share the value of the enterprise with the minority on a *pro rata* basis."[447] In the franchise marketplace, the franchisor may be able to encroach or punitively enforce subjective "standards" to squeeze all the value out of the enterprise and leave the franchisee with nothing.

Encroachment may be motivated by personal animus. In one case, the franchisee was carrying on an affair with the Chairman of the Board of the franchisor, a married man 30 years her senior.[448] Shortly after the affair ended,[449] the franchisor embarked on a course of action which included opening a competing restaurant less than a mile and a half away from the franchisee and undercutting the franchisee with lower prices and promotional coupons, resulting in a 35% sales decline at the franchisee's restaurant.[450]

At the outset, it should be noted that the implied covenant of good faith and fair dealing does not preclude the most savage encroachment. In *Carlock*,[451] the court dismissed the franchisees claims of encroachment by the Häagen-Dazs franchisor, citing a Dunkin' Donuts case[452] in which a store was sited less than a mile away, and a convenience store franchise case where the franchisor opened a competing site four blocks away, thereby driving the franchisee out of business.[453] In Los Angeles, Burger King signed a contract with a franchisee without informing him that Burger King was *simultaneously* negotiating to open a competing restaurant five blocks away.[454] In those cases, the courts failed to apply the covenant of good faith to restrict the franchisors contractual right to open new locations at the franchisor's discretion. As another court explained:

> If the Court were to hold that the instant contracts contain an implied restriction on competition, it would be placed in the unenviable

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http://www.ftc.gov/bcp/franchise/comments/rachid32.htm.

447. Agranoff v. Miller, 791 A.2d 880, 888 (Del. Ch. 2001).

448. Vylene Enterprises, Inc. v. Naugles, Inc., 105 B.R. 42, 45-46 (Bankr. C.D. Cal. 1989).

449. *Id.* at 45.

450. *Id.* at 46. For an analysis by a franchisor's outside counsel, *see* Jeffrey C. Selman, *Applying the Business Judgment Rule to the Franchise Relationship*, 19 FRANCHISE L.J. 111, 114-115 (2000).

451. Carlock v. Pillsbury Co., 719 F.Supp. 791, 812 (D. Minn. 1989) (applying New York law).

452. *Id.* (citing Patel v. Dunkin' Donuts of America, Inc., 496 N.E.2d 1159, 1161 (Ill. 1986)).

453. *Id.* (citing Super Valu Stores, Inc. v. D-Mart Food Stores, Inc., 431 N.W.2d 721, 723 (Wis. Ct. App. 1988)).

454. Barnes v. Burger King Corp., 932 F. Supp. 1420, 1424 (S.D. Fla. 1996).

> position of having to delineate for the parties the boundaries of "fair" competition, that which guarantees to [franchisees] the fruits of their contracts, and "unfair" competition, that which deprives [franchisees] of the fruits of their contracts.[455]

A franchisor told one of the authors when opposing statutory restrictions on encroachment that if under the proposed SBFA a franchise opened in Los Angeles a New York franchisee suffering a drop in business could claim encroachment. In response, the author noted that the majority of case law holds that under a properly drafted franchise agreement, the franchisor could site a competing outlet twenty feet away in a strip mall and the franchisee would have no remedy. The franchisor attorney scoffed "[n]o, they couldn't do that." He was wrong, as was the District Court which had "difficulty foreseeing a situation where a franchisor might develop a new store next to an existing franchise."[456]

Tina Perazzini of Subway stated her employer's policy on encroachment during the 1990's: "We put them up any f***ing place we could."[457] The 2003 Fairfield Research survey showed that 24% of franchisees had been "threatened, encroached upon or coerced into unwanted expansion by their franchisor." Among sandwich franchisees the figure rose to 58%.[458]

Where a brand has strong identity, a franchisee's most threatening competitors, may well be his own franchisor and fellow franchisees. The authors operated a Subway sandwich franchise in lower Manhattan. One day during lunch, a man wearing a Subway uniform began distributing flyers in front of the store. Oddly, customers speaking with the Subway coupon man would turn and walk away from the store. It turned out that the man was giving coupons advertising the "[b]uy one, get one free" special at the Subway up the street owned by another franchisee.

In September 2001, a store employee gestured at the still-burning World Trade Center site four blocks away[459] and taunted passing New York City police officers that the mighty United States could not catch Osama Bin-Laden. The ensuing verbal exchange would have made Tina Perazzini blush, and the employee was given an unpaid leave of absence as punishment. Unfazed, the employee promptly walked to the neighboring Subway and immediately began working, he didn't even need to take off his uniform. Another employee quit, claiming that a

455. Metro Communications Co. v. Ameritech Mobile Communications, 788 F. Supp. 1424, 1433 n.16 (E.D. Mich. 1992).

456. Davis v. McDonald's Corp., 44 F. Supp.2d 1251, 1259 n.9 (N.D. Fla. 1998).

457. Behar, *supra* note 46, at 130.

458. Martin, *supra* note 222, at 8.

459. On conditions at the time, *see generally* Paul Steinberg, *The New York Small Business Market After 9/11*, 30 N.Y. REAL PROP. L.J. 3 (2002).

nearby franchisee had offered to pay her "off-the-books" in order that she could avoid taxes and collect welfare. At a franchisor training session, another franchisee sent his manager to work the room soliciting other franchisees' key employees to quit their current store and work for him instead. Sometimes, franchisees are their own worst enemy.

The *Hobin v. Coldwell Banker* case involved franchises *300 feet* apart.[460] In *Hobin*, the Supreme Court of New Hampshire ruled that the implied covenant of good faith and fair dealing did not prevent encroachment. Cognizant of the conflict between "two apparently inconsistent principles,"[461] the implied covenant and the doctrine that express terms cannot be overridden by the covenant, the court distinguished between cases where good faith could be applied to restrain franchisor discretion where "necessary to protect an agreement which [would] otherwise be rendered illusory" and circumstances where there was *no* restraint because "regardless of how such [discretionary] power [is] exercised, the agreement [is] supported by adequate consideration."[462] What constitutes adequate consideration? A peppercorn does.[463] Peppercorns are the stuff of first-year law school courses on Contracts. In the real world of franchise agreements, the court's ruling means that where the express provisions provide that the franchisor has discretion, the implied covenant of good faith and fair dealing does not exist. For obvious reasons the court could never provide a real-world instance where the covenant would apply. This begs the question, why the court did not simply state (as other courts do) that where the franchise agreement expressly reserved discretion, the covenant does not apply. From reading the decision, it would appear that the court was uncomfortable with declaring the death of good faith and fair dealing. To the extent the implied covenant survives, it is because franchisors are reluctant to harm franchise sales by telling prospects about the consequences of the franchisor's express right to open stores (company-owned or franchised) in competition with the franchisee.

This was the basis for *Scheck*, there is a difference between "you don't have an exclusive territory" and "we can open company-owned or franchised outlets next to you in direct competition for your customers." Most courts do not find a distinction as a matter of law, but there is a distinction to a prospective franchisee. That being said, many people would buy the franchise anyway, believing along with the franchisor

460. Hobin v. Coldwell Banker Residential Affiliates, Inc., 744 A.2d 1134, 1136 (N.H. 2000).

461. *Id.* at 1137.

462. *Id.* at 1138 (quoting Third Story Music, Inc. v. Waits, 48 Cal. Rptr. 2d 747, 752-53 (Cal. Ct. App. 1995)).

463. *Id.*

attorney and court cited above that such a thing would never happen in the real world, even though contractually permitted.

Rarely has a decision so roundly criticized been kept alive as long as *Scheck v. Burger King*.[464] The case is central to a discussion of franchise encroachment, one lawyer referred to "Encroachment: The Nine Lives of *Scheck*."[465] Scheck was a Burger King franchisee, and Burger King converted a Howard Johnson's two miles from Scheck's franchise into a competing Burger King. The issue in *Scheck* was the extent to which the implied covenant of good faith and fair dealing would restrict franchisor encroachment where the contract did not explicitly reserve the right of the franchisor to site competing outlets nearby. Scheck's contract merely noted that Scheck did not have an exclusive territory.[466] There are two issues in *Scheck*-type cases. First, where the franchisor explicitly states that the franchisee will not have an exclusive territory, does the implied covenant of good faith and fair dealing operate as a restriction on the franchisor? Second, if the covenant does restrict the franchisor, does a violation give rise to an independent cause of action where there has been no express contractual violation? In the U.S., the answers to these questions depend on state law, and the states are split. Sometimes, as with *Scheck* and *Weaver*, cases involving the same franchisor and choice of law can result in opposite conclusions.

Legislation such as the SBFA is necessary to prevent abuse of hard-working individuals who put their life savings into a franchise by being left in penury, with nary a peppercorn to call their own. There is no encroachment continuum, as courts have repeatedly ruled in Dunkin' Donuts cases.[467] The Dunkin' agreement provides that:

> DUNKIN' DONUTS, in its sole discretion, has the right to operate or franchise other DUNKIN' DONUTS SHOPS under, and to grant other licenses in, and to, any or all of the PROPRIETARY MARKS, in each case and on such terms and conditions as DUNKIN'

464. Scheck v. Burger King Corp., 756 F. Supp. 543 (S.D. Fla. 1991), *reh'g denied*, 798 F. Supp. 692 (1992).

465. Rupert M. Barkoff, *Encroachment: The Nine Lives of 'Scheck'*, N.Y.L.J., July 27, 2000 at 3. Even courts not following Scheck have noted "the rationale of Scheck is compelling." *See* Chang v. McDonald's Corp., 1996 U.S. App. LEXIS 33288, at *5-6 (9th Cir. 1996).

466. *Scheck*, 756 F. Supp. at 549.

467. Tolstoy observed in ANNA KARENINA: "Happy families are all alike. Every unhappy family is unhappy in its own way." Unhappy franchise systems share this trait; just as Carvel and Häagen-Dazs set the standard for alternate distribution channels, and Subway for arbitration as a means of denying franchisee remedies, so Dunkin' Donuts has replaced Burger King as the standard-setter for physical site encroachment. Dunkin' has taken the process one step further, telling franchisees that it has a policy to review encroaching sites but then ignoring the findings of the review.

> DONUTS deems acceptable.[468]

When a franchisee claimed an encroaching site violated the covenant of good faith and fair dealing, the court held that "the agreement authorizes [Dunkin's] unrestricted competition."[469]

Market saturation is not necessarily bad, as franchisor attorney David Kaufmann explains:

> Saturating the marketplace with as many points of distribution as possible to maximize retail opportunities; make procuring a company's products or services as easy, convenient and swift as possible; and, to heighten a company's name recognition and consumer awareness is a retail concept hardly restricted to franchising.[470]

True enough. As one franchisor attorney has noted, Starbucks[471] saturates a market, why shouldn't a franchisor do the same?[472] The distinction is that when Starbucks errs, it harms only itself. When a franchisor encroaches upon a franchisee, the franchisor is better off and the franchisee is worse off. The encroachment equation is expressed as Marginal Revenue Product. Marginal Factor Cost (MRP. MFC).[473] To understand why market saturation benefits the franchisor long after it has become counterproductive for the franchisee, it is first necessary to address Kaufmann's assertion in terms of expansion of demand, cross elasticity[474] of demand, and product substitution.

As discussed previously, a trademark should add value in the mind

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468. Patel v. Dunkin' Donuts of America, Inc., 496 N.E.2d 1159 (Ill. App. 1986).

469. *Id.* at 1161.

470. DAVID J. KAUFMANN, *Network Expansion/ Dual Distribution/ Encroachment*, *in* UNDERSTANDING FRANCHISING: BUSINESS AND LEGAL ISSUES 503, 507 (Practising Law Institute, 2001). Kaufmann is a prolific writer and lecturer on franchising, and authored the New York State franchise law. He now exclusively represents franchisors.

471. Starbucks is not a franchise, although 80% of consumers believe it is a franchise. *See* Cobo, *supra* note 172, at 183. *See also International Franchising* (Sponsored section in *Intl. Herald Tribune*, May 18, 2001) (on file with author) (claim that Starbucks is a "publicly traded franchise").

472. Posting of Byron E. Fox, byronfox@worldnet.att.net, to Franchising@mail.abanet.org (Aug. 26, 2002) (hardcopy on file with author) (listserv is run by the ABA Forum on Franchising).

473. Where the increase in revenue (franchise fees, royalties, ad fees, rebates, financing charges, etc.) due to the addition of a franchised outlet is expressed as MRP (Marginal Revenue Product) and the cost of servicing that franchised outlet (headquarters support, compliance audits, etc.) is expressed as MFC (Marginal Factor Cost), then the franchisor should encroach where MRP. MFC. Note that economies of scale will operate to reduce MFC as the system expands.

474. "Products that are similar to each other, that are substitutes for each other, display positive cross-elasticity. That is, if the price of A remains constant, an increase in the price of B will generate more sales of A as buyers switch to it." Photovest Corp. v. Fotomat Corp., 606 F.2d 704, 713 n.12 (7th Cir. 1979).

of the consumer. The more ubiquitous a trademark is, the more frequently a trademark registers in the mind of the consumer and the consumer will perceive the brand to represent quality; after all, if Starbucks is on every street corner, it must be great coffee, right? And when you think of going out for coffee, what store comes to mind? That is what marketers call "top of mind awareness," and franchisors commission studies to ensure that their advertising agencies are increasing top-of-mind awareness. Kaufmann is correct that market saturation will increase gross market share both due to increased convenience and increased awareness.

Kaufmann's writings intertwine concepts of brand substitution and cross elasticity of demand. Brand substitution occurs when a consumer perceives a relative difference in convenience, quality or price. Cross elasticity of demand is a formula[475] measuring the variable responsiveness of the quantity demanded to a change in the price of another good, and is the economic rationale for the recent 99-cent burger wars among the major franchisors. Kaufmann is correct insofar as the "price" of a good includes the consumer "cost" (driving time and gasoline) to obtain the product. Increasing franchise density reduces the "price" the consumer must pay to obtain the good, and therefore leads to a rise in demand for the (franchisee-retailed) good.[476]

Kaufmann's flaw is his failure to consider that franchising is a peculiar subset of retailing, and marketing and economic paradigms need adjustment accordingly. Cross elasticity of demand is not conventionally thought of as part of an intra-brand profitability analysis, but it should be in franchising.[477] Kaufmann fails to account for intra-brand cross

475. Elasticity is customarily represented as a Cartesian coordinate graph with quantity plotted on the x-axis and price on the y-axis. *See* WALTER J. WESSELS, ECONOMICS 293-309 (3d ed. 2000). Slope is rise divided by run. Most products have a negative slope, since the higher the price the less output is demanded. However, some luxury goods such as high-end cars, college tuition, and real estate can have a positive slope where consumers perceive a correlation between high quality and high price. *Cf.* Louise Kramer, *Restaurateurs put Eateries Under the Knife*, CRAIN'S N.Y. BUSINESS, Sept. 16, 2002 at 4 (quoting owner: "[i]n this business, it used to be better to be thought of as expensive . . . if it cost more, people would think it was better"), *accord* Alex Kuczynski, *Lifestyles Of the Rich And Red-faced*, N.Y. TIMES, Sept 22, 2002, Section 9 at 1, 8 (noting that decorator clients "don't enjoy the purchase unless they know they have spent a lot of money for it.").

476. Theoretically at least, a franchisee could increase the retail price to the consumer to capture some of the reduction in cost to the consumer of obtaining the product. But this would be quickly offset by increased intra-brand competition, whose decline in profits (both nominal total and marginal rate) would be borne primarily if not exclusively by the franchisee.

477. The substituted product is another outlet of the same franchisor. The probable reason that franchisors don't use cross elasticity of demand is that it would necessarily involve admitting publicly that the interests of the franchisor and franchisee are at odds,

elasticity of demand, where demand is unitary elastic[478] and hence a post-sale constraint on franchisee pricing latitude not disclosed in any UFOC this author has ever seen. To some extent, a franchisee can attempt to get around this by intra-franchise differentiation.[479] However, the flaw in Kaufmann's logic is laid bare when one considers that intra-*brand* differentiation (which is the result of intra-*franchisee* differentiation) negates a primary premise of franchising.

The whole point of franchising is uniformity, and in a well-run franchise the customer can compare the price of apples to apples. The raison d'etre of franchising *is* fungibility.[480] This creates an anomalous situation in cases of franchisor encroachment: unit price falls and franchisor output rises on increased profitability; simultaneously franchisee output declines on reduced profitability. The economically rational courses of franchisor and franchisee are diametrically opposed.

> Example: Franchisee A located on First Street is grossing $20,000/week. Franchisee B on Eleventh Street is grossing $10,000. Franchisor feels that Franchisee B is substandard and wishes to push B out of the system. Franchisor sites Franchisee C on Ninth Street. The Ninth Street outlet captures $5,000 from Franchisee A and $5,000 from Franchisee B (because it is closer to B) and creates new demand of $5,000. The franchisor already services Franchisee A and B, so the addition of Franchisee C does not impact MFC but MRP increases by the royalties on an additional $5.2 million over a 20-year franchise agreement. Even discounted to present value, that's respectable MRP. In addition, the franchisor gets a franchise fee, ongoing advertising fees, a real estate surcharge on the sublease, royalties from the sale of the logoed products which Franchisee C must purchase to outfit the new location, etc. In addition, the advertising fees contributed by A, B, and C can be used at the periphery of the trade area, or even on national placements, which will further franchisor expansion and provide little or no benefit to A,

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and that franchisees are competitors among themselves, and the franchisor benefits from internecine competition so long as pricing is systemically optimal.

478. Demand is elastic where a price change causes a greater change in demand; inelastic where a given price change causes a smaller change in demand; demand is unitary where there is a 1:1 correlation between price and demand changes. Most products have a combination of elastic, inelastic and unitary features depending on the specific price/quantity coordinates being compared.

479. For example, product line, visual merchandising, customer service, etc.

480. W. MICHAEL GARNER, FRANCHISE & DISTRIBUTION L. & PRACTICE § 2:3 at 3 (1990) (noting that essential concept of franchise is uniformity of product or service). There are occasional exceptions. *See* Linda Lee, *Times Square, With Ketchup*, N.Y. TIMES, Sept. 25, 2002 at B1 ("McDonald's corporation, once the enforcer of a clonelike 1950's uniformity, now takes a do-your-own-thing attitude about decoration.").

B, and C whose dollars pay for the advertising.[481]

The tautology that output is a function of input can be seen in the example above. Input is comprised of capital and labor, and is the MFC of the encroachment equation. In the example, the inputs are provided almost exclusively by Franchisees A, B, and C. More importantly, the franchisor has near zero input cost on Franchise C, but the input of Franchisee C results in an increase in output (MRP) captured by both franchisor and Franchisee C. However, since MFC is so low for the franchisor,[482] the incentive to encroach is great, particularly where longer-term costs (such as legal expenses, systemic declines in franchisee profitability, and increased reputational costs) can be managed through artful drafting of the franchise agreement.

Encroachment impacts more than gross sales. Gross sales impact can be significant and lasting, and is the most easily quantified damage.[483] But the more subtle impacts of encroachment can be more damaging, and may go unnoticed by an unsophisticated franchisee. Most franchisors make their money based in some form on the gross sales of an outlet, whereas franchisees make money based on net income. Franchisor encroachment is particularly effective with products having high price elasticity, since franchisees must charge sub-optimal unit price to avoid customer defections to the nearby competing franchisee. In the example above, for example, Franchisee A may have invested his life savings on a business plan predicated on a 40% Cost of Goods Sold (COGS). But in order to keep customers who would otherwise defect to B or C, Franchisee A lowers the selling price. The franchisor and vendors are still charging the same wholesale price, so the percent COGS now rises, eroding or even eliminating profitability. It is a valid

481. This is a respected expansion strategy in marketing. For example, Target and Kohl's department stores have recently done extensive television and outdoor media prior to entering the New York City market; brand awareness is likewise a precursor to franchisor expansion into virgin territory.

482. The Print Three franchisor was able to set up an entire competing franchisor named Le Print Express without adding staff. *See* Shelanu Inc. v. Print Three Franchising Corp., [2000] 2000 Ont. Sup. C.J. LEXIS 2369 at *26-27. Tricon (Taco Bell, Pizza Hut, KFC) collected $830M in franchise fees in 2001 and noted that cost of collection was low. *See* Papiernik, *supra* note 203. And AFC Enterprises (Popeye's, Church's Chicken, Cinnabons) told financial analysts that 70-90% of franchise revenue collected by the franchisor was profit. *See* James Peters, *AFC A Ringing Success in First Year as Public Company Despite Soft Economy*, NATION'S RESTAURANT NEWS, Mar. 11, 2002 at 4, 61.

483. For example, as a franchisee, this author experienced an immediate 25% sales decline following the opening of a competing franchise less than four blocks away, and the decline remained more than a year later. In fairness, the franchisor had taken steps to minimize the impact by limiting operating hours of the new location and was surprised by the magnitude and duration of the impact.

complaint of franchisors that franchisees are more prone to supra-optimal pricing, franchisees are ill-advised to exceed the franchisor's suggested retail price both for reasons of franchise uniformity[484] and long-term profit maximization.[485] Although maximum price maintenance may be permissible,[486] franchisors can avoid antitrust concerns by pitting franchisees against each other to increase gross sales. The incremental cost of the increased revenue to the franchisor is likely to be insignificant. Hence, the increased revenue to the franchisor will provide the highest margins, particularly in a less mature system where the franchisor has excess capacity to service new outlets.[487] Whether this is true for the franchisee depends on factors related to elasticity and variable operating costs. In any event, where the franchisor is well managed, encroachment is an economically rational act where the goal is profit maximization.[488] Moreover, if the franchisee is pushed to abandon the franchise (rather than being terminated), the franchisor has a stronger claim for loss of future royalties.[489] In that instance, the franchisor gets a newly-built outlet paid for by the new franchisee, increased sales, and double royalties[490] by virtue of a claim against the old franchisee. Courts, however, have begun to look with skepticism at lost future royalty claims.[491]

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484. Customers are aware of prices, and expect relative uniformity on prices within the same market area. This conclusion is supported not only by internal franchisor research reviewed by this author, but by this author's own experience as a franchisee.

485. Although a small franchisee probably doesn't know the price elasticity of the product, a large franchisor probably does have some idea. A franchisor has a greater amount of market sales data, and presumably is better equipped to determine the optimal retail price. Of course, that optimal price may be different for franchisor and franchisee, and the question becomes whether the franchisor will balance the interests in setting a suggested retail price. When McDonald's promoted a $1 burger, franchisees complained that they were losing money. *See* Amy Zuber, *Discounting not a Quick Fix for Fast Feeders*, NATION'S RESTAURANT NEWS, Nov. 25, 2002 at 1, 54 (franchisee says McDonald's must cut rent, give money to operators, or raise the prices).

486. SULLIVAN & GRIMES, *supra* note 258, at §§ 6.7a, 6.7b (2000).

487. In a mature system, the excess capacity issue is less significant since economies of scale have likely driven marginal factor cost to a low level anyway.

488. I refer to immediate profit maximization. To analyze the long term consequences, it is necessary to discount to present value costs such as increased litigation and reputational damage. While those factors are discussed elsewhere in this paper, it suffices to say that those costs have not acted as a deterrent to any franchisor of which this author is aware.

489. Barkoff, *supra* note 140, at 3 ("recovery of loss of future revenue seems to depend on who blinks first"). A franchisee terminated for failure to pay royalties may escape payment of lost future royalties. *See* Burger King Corp. v. Hinton, Inc., 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002).

490. The franchisee could seek to show that the new outlet, which may effectively be a relocation insofar as it draws from an almost identical trade area, reduces any claim for lost royalties since any computations are speculative.

491. Rupert M. Barkoff, *Recent Precedents say Recoveries for Lost Future Royalties*

The example above shows how encroachment makes economic sense in the short term for the franchisor. Franchisors maintain that this wouldn't happen since it would kill the golden goose by driving franchisees into bankruptcy, and ending the royalty stream. A commentator in the IFA publication Franchising World criticized those who complain of encroachment: "A franchisor doesn't deliberately try to take business from his franchisee, that decreases royalty. Royalty is his income."[492]

This statement is incorrect, for several reasons. First, a reduction in profitability for the encroached franchisee does not mean a reduction in franchisor royalties; as shown above there is often an inverse relationship. Second, reduction in franchisee profitability logically results in a diminution in resale value of the franchise. Franchisee recognition of that diminution upon sale may trigger the need for cash contribution to cover collateralized loans; sunk costs and prospective exit costs keep the franchisee in the system despite the reduction in franchisee income. Third, a franchisor has the ability to make it difficult for a franchisee to exit the system,[493] so a franchisee may remain even when barely eking out a living. Fourth, the franchisor has conditioned the franchisee to think of himself as an "owner" of the business, and admitting defeat may be psychologically difficult, particularly when the franchisee's loss results in no loss to the "partner" franchisor, who merely inserts a new franchisee serf in his place. Fifth, at least in the short run, the franchisor may be able to convince franchisees that market saturation will ultimately result in increased sales. The franchisor may even give financing (collateralized and with a healthy down payment) to encourage franchisee overexpansion, and the franchisor's regional developer may be required to over-saturate the region in order to keep regional development rights.[494]

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aren't Likely, FRANCHISE TIMES, May 2003, at 46 (citing the *Sealy* and *Hinton* cases; noting that *Sealy* was a California "Left Coast" decision but *Hinton* was from the same court that in *Weaver* rendered a pro-franchisor decision reversing *Scheck*).

492. Tom Murphy, *Federal Legislation Could be Demise of Franchising*, FRANCHISING WORLD, Apr. 2001, at 50, 51.

493.

494. *Cf.* In the Matter of Doctor's Associates, Inc. and Tom O'Neill and Scott Linkletter, Bus. Franchise Guide (CCH) ¶ 12,098 (Resolutions LLC, filed June 1, 2001). Per written contract, local Subway agent must open more stores than any competitor or face termination, the loss of everything the local agent had struggled to build would revert to the franchisor. *Id.* This clause is present in most Subway contracts with regional agents, but is not disclosed to prospective franchisees in the UFOC. Prudent franchisors avoid creating privity between the regional agent and the franchisee, but this does not obviate the need for disclosure of relevant information to the franchisee. *See* Rupert M. Barkoff, *Three-Level Systems: Problems Facing the 'Cheese' in the 'Sandwich'*, N.Y.L.J., July 24, 2003 at 3 (noting legal issues regarding "middleman"

Because most courts hold that a franchisor may encroach at will if the franchise agreement is artfully drafted, the franchisee may be confronted with a Hobson's choice: build the new location or someone else will. Psychology and sunk costs may impel the franchisee to build the new site. For the franchisee, such a situation is lose-lose. But the franchisor who bears little risk is in a win-win position. In fact artful use of "agree to agree" and "conform to current" contract clauses mean that the franchisor will capture the goodwill created in the past by the local franchisee and also that the franchisor will capture an increased future revenue stream from the original franchise.

Franchisors may also have an economic motivation to reduce franchisee profitability through encroachment. The Fotomat franchisor maintained a policy of encroaching in order to limit gross sales to $70,000 per kiosk.[495] The court noted that the effect was to prevent the franchisee from attaining the 3-year projection that the franchisor had discussed in the sales literature. In order to quickly expand nationwide, the franchisor decided to expand through franchising. In the early years it derived more income from franchise sales than from operations.[496] When Fotomat decided to recapture the Indianapolis market from the franchisees, it deliberately encroached in order to buy out franchisees at the lowest possible price.[497]

Some franchisors such as Cingular[498] and Häagen-Dasz view their franchisees as "Beacons on the Street"[499] to raise the profile of the brand in order to funnel customers to distribution outlets more profitable to the franchisor. Conversely, the Subway sandwich chain has 20,000 franchised outlets and only one company-owned test store. Franchise legislation should distinguish between a "Häagen-Dasz" and a "Subway" encroachment; the former is much more prone to franchisor bad faith than the latter, because MRP is much greater and the potential for abuse of franchisees greater as well. Moreover, reputational damage is more likely to be a curb on "Subway" encroachment than "Häagen-Dasz" encroachment. This is particularly true where the franchisor has built trademark value on the backs of the franchisees and now desires to eliminate or reduce the franchisees to a "tactical marketing tool."[500]

An additional factor where franchisors encroach with company-

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between franchisor and franchisee).

495. Photovest Corp. v. Fotomat Corp., No. IP 74-705-C 1977 U.S. Dist. LEXIS 15832 at *62 (S.D. Ind. May 18, 1977).

496. *Id.* at *21.

497. *Id.* at *93.

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499. Carlock v. Pillsbury Co., 791 F. Supp. 719, 818 (D. Minn. 1989).

500. *Id.* at 818.

owned outlets is franchisor access to the franchisees' financial and market data. In 1992, a Sheraton Atlanta airport franchisee ceased receiving bookings through the Sheraton reservation system. Sheraton Reservations claimed computer error but refused to compensate the franchisee.[501] Sheraton Reservations also overbilled the franchisee and demanded that the franchisee pay the charges and pursue a refund.[502] Around the same time, Hyatt offered to sell Sheraton an Atlanta airport property at a low price.[503] The Sheraton employee in charge of the acquisition felt that two Atlanta franchisees needed to be terminated from the Sheraton system, and prepared internal documents to that effect.[504]

By May 1993, Sheraton had purchased the Hyatt property and converted it to a Sheraton company-owned hotel.[505] Tom Faust, formerly the Sheraton Reservations manager, was made manager of the company-owned hotel. Faust used "confidential, competitively sensitive information from the Reservation system concerning the franchisees" to support his argument to the franchisor employer that the franchisees should be "ejected" from Sheraton.[506] Faust had detailed data on the rates, occupancy, discount policy, marketing plan, and operating expenses of the franchisee.[507] The franchisee presented evidence that Faust may have used the data to take customers away from the franchisee.[508] Sheraton Reservations claimed that it was not discriminating in favor of the company-owned property managed by former Sheraton Reservations manager Faust, but the franchisees claimed otherwise based on their own 300 test calls to Sheraton Reservations.[509]

In applying a *Scheck* analysis, the court noted that while Sheraton had put the franchisee on notice that Sheraton reserved the right to place competing *franchises* anywhere the franchisee did not have notice that he would be competing with a *franchisor*-owned outlet.[510] The court noted that if Sheraton had placed the franchisee on notice, the franchisee would

501. Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., 139 F.3d 1396, 1401 (11th Cir. 1998).

502. *Id.* The errors were due to the SABRE reservations system. *See id.* When the reason was discovered, Sheraton Reservations credited some money back, but, the franchisee claimed, still overbilled $1800. *Id.* at 1407.

503. *Id.* at 1401.

504. *Id.*

505. *Id.* The Hotel was owned by wholly-owned subsidiary of franchisor. *See id.*

506. *Id.* at 1402. Sheraton admitted this, but claimed it did not act on Faust's recommendation. *Id.* at 1406.

507. *Id.* at 1410 (discussing Georgia Trade Secrets Act).

508. *Id.*

509. *Id.* at 1402, 1406.

510. *Id.* at 1404.

have no recourse.[511] In contrast to the controversy which greeted *Scheck*, six years later *Camp Creek* was quietly received within the franchise industry, which realized that "artful drafting" could enable encroachment, just as the *Scheck* court had tried to explain.[512]

Many franchisees fail to understand that they are entering into a Faustian bargain with their franchisor. Franchisors often claim that they don't have sufficient data to provide prospects with revenue and profit numbers, but then use the same data to surgically cannibalize their franchisees. Data can be used when determining which locations to defranchise, refranchise, and encroach with company outlets. Sometimes this is part of a public strategy by the franchisor. The Merrill Lynch analyst following Krispy Kreme noted the discrepancy between 20.9% comps[513] at company-owned outlets, 11.8% at older franchises and 1% for newer franchises.[514] The analyst stated that Krispy Kreme admitted some cannibalization but said it was part of a strategy for the franchise to achieve "critical mass" in a few years.[515]

Franchisors tell their "partner" franchisees that there are written guidelines followed by the franchisor and imply that the franchisor acts in good faith in determining where to site new outlets. Franchisors are *not* liable for fraudulent misrepresentation where they promise a prospective franchisee that the franchisor will not encroach the franchisee, since failure "to make good subsequent conditions which have been assured" or otherwise fulfill "an agreement to do something at a future time" is breach of contract, not fraud.[516] Moreover, a properly drafted integration clause will result in summary judgment in favor of the franchisor on a claim for breach.[517] If the franchisor does not place the encroachment policy within the franchise agreement, an integration

511. *Id.* at 1405 n.12.

512. *See* Robert Zarco & Lawrence V. Ashe, *The Sounds of Silence in the Franchise Agreement*, 19 FRANCHISE L.J. 1 (1999) (analyzing the two cases).

513. Same-store comparable sales relative to prior year for stores open at least one year.

514. Richard Papiernik, *Analysts say Future may Tarnish Krispy Kreme Glaze*, NATION'S RESTAURANT NEWS, Mar. 26, 2001, at 11, 69.

515. *Id.* Within two years, the effects were as predicted. James Peters, *Krispy Paradox? Weekly, Same-store Rates at Odds*, NATION'S RESTAURANT NEWS, Sept. 29, 2003, at 1.

516. Cook v. Little Caesar Enterprises, Inc., 972 F. Supp. 400, 410 (E.D. Mich. 1997). The rationale is that "fraud must relate to facts then existing or which have previously existed." *Id.*

517. *See* Whalen v. Connelly, 545 N.W.2d 284 (Iowa 1996) (discussing fraudulent inducement claims). Some inducement claims may also be barred by the economic loss rule, notwithstanding the rise of the "contort" many courts sharply distinguish between contract and tort. *See* Hotels of Key Largo, Inc. v. RHI Hotels, Inc., 694 So. 2d 74, 77 (Fla. Dist. Ct. App. 1997).

clause will likely preclude a franchisee cause of action.[518]

Even where the policy is incorporated in the franchise agreement the policy may be illusory. Dunkin' Donuts has such a mechanism for franchisees to dispute prospective encroachment. As seen, however, in *Harford Donuts v. Dunkin' Donuts*,[519] Dunkin' Donuts simply ignores analyses which show cannibalization and opens the new location. In *Patel v. Dunkin' Donuts*, the appellate court dismissed franchisee evidence that the Dunkin'-approved grievance committee found that the new site would "significantly encroach" by observing that Dunkin' was not "contractually bound" by the committee finding.[520] In *Kirkwood Kin v. Dunkin' Donuts*, the franchisees alleged violation of the covenant of good faith on the grounds, *inter alia*, that Dunkin' had violated the covenant by failing to consult with the franchisees prior to opening two competing outlets. In holding for Dunkin', the court observed that if the franchisee lacks veto power, "what good would prior consultation do, other than perhaps assuage any fears the existing franchisee might have? . . . parental 'hand holding' [is not] a requirement of the covenant."[521] But the next year, a Dunkin' franchisee who failed to seek the parental hand holding on the grounds that "no one . . . has gotten anywhere with those programs" was told by the court that his claim was "flawed because he failed to avail himself" of Dunkin's encroachment procedure.[522] The rulings demonstrate the lack of mutuality in the franchise relationship. A franchisee must give the franchisor an opportunity to discuss encroachment on the off chance that the policy will not always be a sham. However, a franchisor does not have to submit to the encroachment dispute resolution procedure where the franchisor has a contractual right to encroach, and knows that it will ignore the results of any study not in the franchisor's favor.

Many franchisors have encroachment dispute resolution policies similar to Dunkin' Donuts, and franchisees are induced to rely on the policies. Indeed, franchisor salespeople proudly point to such policies to show that the franchisor is concerned about expanding in manner which will not harm the prospective purchaser's investment. In December 1990, when the Chief Executive Officer of Carvel was asked by franchisees about rumors that Carvel would enter into the supermarket distribution market, he denied the rumor, adding that that strategy had

518. Davis v. McDonald's Corp., 44 F. Supp. 2d 1251, 1258 (N.D. Fla. 1998).

519. Harford Donuts, Inc. v. Dunkin' Donuts Inc., No. Civ. L-98-3668, 2001 WL 403473 (D. Md., Apr. 10, 2001).

520. Patel v. Dunkin' Donuts, 496 N.E. 2d 1159, 1161 (Ill. App. 1986).

521. Kirkwood Kin Corp. v. Dunkin' Donuts, C.A. No. 94c-03-189-WTQ, 1997 Del. Super. LEXIS 30 at *51 (Del. Super. Ct., Jan. 27, 1997).

522. Dunkin' Donuts Inc. v. Panagakos, 5 F. Supp. 2d 57, 64 n.20 (D. Mass. 1998).

"ruined" Haägen-Dazs' shops.[523] By the fall of 1992, Carvel was "testing" a supermarket program and by April 1993 there was a full rollout of the program over franchisee objections.[524]

Where a franchisor has a history of such behavior, regulators must ask whether an Offering Circular which enunciates the encroachment policy is fraudulent, given the illusory nature of the policy. Franchisees should be explicitly and prominently informed in the disclosure documents that the franchisor can and does ignore its own policy, and will site encroaching outlets even if it results in the existing franchisee going out of business.

Encroachment may take place for both economic and punitive reasons. While a factual inquiry into franchisor motivation is more complex than a bright-line standard, good faith may be applied at the second stage of an encroachment analysis. Where the franchise agreement provides explicit and prominent notice that the franchisor may site a location adjacent to an existing location, the burden would shift to the franchisee to demonstrate that the franchisor had encroached for the purpose of forcing the franchisee to surrender possession or be forced into economic ruin.[525] One of a franchisee's obligations is to pay certain sums to the franchisor for the term of the agreement, and good faith includes "an implied undertaking on the part of each party that he will not intentionally and purposely do anything to prevent the other party from carrying out the agreement."[526] Where an encroaching franchisor bankrupts a franchisee, the franchisee has not only been denied the fruits of his contract, he is prevented from fulfilling the franchise agreement.

C. Franchise Inspections & Audits

As then-Chief Judge of the First Circuit, now-Justice Breyer observed that where compliance with a rule is inordinately difficult, the resulting ability of the rulemaker "to pick and choose when and where to enforce the rule . . . destroys in practice the very hope of rationally cabining [the rulemaker's] discretion."[527] The subjective nature of franchisor inspections gives rise to selective enforcement designed to keep franchisees in line.[528]

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523. Carvel Corp. v. Baker, 79 F. Supp. 2d 53, 56 (D. Conn. 1997).

524. *Id.*

525. *See Far Horizons*, *supra* note 80, at n 6. The court found that McDonald's did not act in bad faith and so did not pursue the desirability of such a test. *See id.*

526. Carvel Corp. v. Diversified Mgmt. Group, Inc., 930 F.2d 228, 230 (2d Cir. 1991).

527. U.S. v. Data Translation Inc., 984 F.2d 1256, 1262-63 (1st Cir. 1993).

528. *Cf.* SULLIVAN & GRIMES, *supra* note 258 at § 8.2b.1 (citing the *Mobil* and *Southland* cases). Even under the PMPA, franchisor motives for termination are

Franchisors can choose the optimal time to make a punitive inspection. A Canadian Radio Shack franchisee was named Manager of the Month in December and then sent a warning letter in January based on the store inspection conducted right after Christmas; the franchisee pointed out that he had been working 85-90 hours per week and that both he and the staff were exhausted and in any event the retail customers would not see the disorganized backroom and office.[529] McDonald's instituted a grading system which some franchisees viewed as a means to force small franchisees to sell out to larger operators. One of the more contentious points was the degree of restroom cleaning during lunch. The criteria made it easy for McDonald's to get the grade it wanted to give: a franchisee attorney noted that during lunch rush "it is inevitable that some towels will end up on the floor unless someone is standing guard."[530] Conversely, although the franchisor-mandated "Made For You" program created many customer service problems, an industry consultant said that McDonald's inspections focused on "dust on windowsills and cigarette butts in the landscaping . . . [o]ne of the reasons that inspectors don't focus on service is that they have no solutions to the problems created by Made For You."[531]

The authors have spoken with a donut franchisee active in organizing a franchisee association. The franchisor knew when the shop would receive its weekly supply delivery and inspected the shop just after delivery. Among other items, the franchisor noted that the delivery which had just been unloaded was not completely put away, despite the franchisor observing an employee putting the delivery away during the inspection. The franchisor graded the store as "89" and then denied the franchisee's pending bid for an expansion site since the franchisee needed to score "90" to expand.[532]

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irrelevant where the franchisor bases termination on an act or omission of the franchisee. *See* Glenside West Corp. v. Exxon Co., U.S.A., 761 F. Supp. 1100, 1109-1110 (D. N.J. 1991). Franchisor counsel tell clients that "several courts have concluded that franchisors are free to treat individual franchisees differently without facing any legal consequence." Gordon W. Schmidt & John R. Gotaskie, Jr., *Enforcement of System Standards: What's a franchisor to do?*, FRANCHISE TIMES, Oct. 2000 at 44, 45. The authors are lawyers with Doepken, Keevican & Weiss P.C. *See id.*

529. Head v. Inter Tan Canada Ltd., [1991] 1991 Ont. C.J. LEXIS 513 at *4, *15, *18.

530. Amy Zuber, *Slow Economy Feeds Fast-food Fight: Industry Observers say Franchisees Hard Pressed to meet Franchisor Expectations*, NATION'S RESTAURANT NEWS, Jan. 21, 2002 at 28, 29.

531. Amy Garber, *McD Smiles at Sales rise; Reaction Cautious*, NATION'S RESTAURANT NEWS, July 28, 2003 at 5,167 (quoting Dick Adams of Franchise Equity Group). Sixty-five point five percent of customer complaints were related to service. *Id.* (quoting a Smith Barney analyst's report).

532. Similar allegations of retaliation for franchisee organizing activities were made against the Popeye's chicken franchisor; in declining to grant summary judgment the

Franchisor inspections can also be used to provide a pretext to prevent franchisee growth, permit franchisor cannibalization of existing franchisees, provide leverage to gain franchisee acquiescence to franchisor demands, and punish franchisees resisting those demands. In early 1982, Dunkin' Donuts wanted franchisees to sign a modification to the advertising policy.[533] Shortly after Katherine Apostoleres, a franchisee since 1976, refused to sign both her stores were audited.[534] In reviewing the jury verdict in favor of Apostoleres, the appellate court affirmed the magistrate judge's finding that sufficient evidence existed for a jury to conclude that the 1982 audits were "substantially motivated by Mrs. Apostoleres' refusal" to sign the new Dunkin' agreement and "the terminations were not based on good cause because there was no intentional underreporting."[535]

A Taco Bell franchisee "who had regularly received C's, B's, and A's on [franchisor evaluation] scores, began to get F's"[536] the month after signing a letter releasing Taco Bell from claims resulting from Taco Bell's opening of corporate-owned restaurants in competition with the franchisee. Adding insult to injury, the corporate locations were originally found by the franchisee, who was denied permission to open at the sites ostensibly because the restaurants did not meet Taco Bell criteria for store sites.[537] In quashing Taco Bell's subpoenas for "highly personal and sensitive financial data" of the franchisee plaintiff and his wife Iris, the magistrate judge found "the manner in which [Taco Bell] proceeds . . . is indeed heavy-handed and quite apparently designed to harass and embarrass both the plaintiffs and [non-party] Iris Cohn."[538] Taco Bell, which successfully overcame an independent franchisee association in the early 1990's in part by allegedly refusing to permit expansion,[539] now has a more docile association which opposes renegade

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court found that the franchisees had raised a genuine issue as to whether Popeye's refused to approve a prospective purchaser based on the purchaser's activities in the Franchisee Association, as well as the purchaser's ethnic origin. Popeye's, Inc., v. Yuzo M. Tokita; Fima & Assocs. v. America's Favorite Chicken Co. (Consolidated Cases), 1993 U.S. Dist. LEXIS 13295, *30-31 (E.D. La. 1993).

533. Dunkin' Donuts of America, Inc. v. Minerva, Inc., 956 F.2d 1566, 1568 (11th Cir. 1992).

534. The audits took place in August 1982; Dunkin' claimed the audit had been scheduled prior to Apostoleres' refusal to sign. *Id.* at 1570. Another audit of both stores took place in Sept. 1985, and a termination letter was sent in June 1986 based on allegations of underreporting at one of the two stores. *Id.* at 1568.

535. *Id.* at 1570.

536. Richard L. Cohn & RLC Enterprises, Inc. v. Taco Bell Corp., 1993 U.S. Dist. LEXIS 165 *4 (N.D. Ill. 1993) (adopting order of Feb. 12, 1993, *reprinted at* 1993 U.S. Dist. LEXIS 1732).

537. *Id.* at *2-3.

538. *Id.* at *12-13.

539. Dunafon v. Taco Bell Corp., 1996 U.S. Dist. LEXIS 22026 at *5 (W.D. Md.

operators and forwards media inquiries to the franchisor.[540]

Franchisors have leverage in internal franchisee association politics; AAMCO franchisees alleged that the franchisor gave a choice site to a franchisee who ousted two association board members that had won a lawsuit against the franchisor on behalf of the association.[541] Despite the risks of forming associations, franchisees have been prodded by franchisor action to organize, and the number of franchisee associations grew from less than 30 in 1992 to 250 by 2001.[542]

Underreporting is a problem for franchisors, particularly in a cash business. The authors have listened as franchisors and their attorneys waxed in high dudgeon, believing franchisees to be the fountainhead of this heinous offense. But in matters of cash handling, franchising is no different from any other non-franchised business. Indeed, it is no different from the problem faced by a franchisee faced with cash shortages due to theft, or the retail industry phenomenon euphemistically known as "inventory shrinkage." In the authors' experience as an auditor of cash businesses[543] and later as a franchisee auditing the cash drawer each day, the human compulsion to filch a few dollars from the till appears more prevalent than not. And we would concede that many business owners, including franchisee-owners, keep duplicate sets of books.[544] For this reason, audit controls are put in place. These may be cash controls, inventory controls, random audits, "secret shoppers" and

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1996) (Franchisee alleged that in Feb. 1993 Taco Bell President stated that leaders of Intl. Assn. of T.B. Franchisees [IATBF] not permitted to expand. Count dismissed on choice-of-law rationale. *Id.* at *9-13.). IATBF gave media interviews, "Taco Bell did not appreciate the media attention, referring to IATBF leaders as 'renegades and scum,'" Dunafon v. Taco Bell Corp., 1997 U.S. Dist. LEXIS 22468 at *2 (W.D. Mo. 1997). *See also*, *Franchising Relationship*, *supra* note 49, at 66. (statement of Darrell Dunafon, Dunafon Real Estate Development, Sandella's Franchise, Former Taco Bell Franchisee).

540. Amy Spector, *Tricon mounts Taco Bell bailout: Store Buybacks, Debt Waivers Eyed as 'Refranchising' Criticized*, NATION'S RESTAURANT NEWS, Feb. 26, 2001, at 1, 44 (quoting franchisee association President John Antonaccio and Antonaccio message opposing group seeking to form non-franchisor sanctioned association).

541. AAMCO Transmissions, Inc. v. Graham, 1990 U.S. Dist. LEXIS 5037 at *4-5 (E.D. Pa. 1990).

542. Mary Jo Larson, *Associations: Evolving and Here to Stay*, FRANCHISE TIMES, Sept. 2001, at 19 (quoting Joe Schumacher of Fisher Schumacher & Zucher).

543. From 1985-1987, one of the authors was assigned to the U.S. Marine Corps Nonappropriated Fund Audit Service in Jacksonville, N.C. and audited military clubs, chapels, and recreational activities.

544. We would quickly note for the benefit of the audit department of our former franchisor that to "concede" tax cheating by cash businesses should not lead to the conclusion that we kept such books ourselves as franchisees, but rather that we are a "knowledgeable" "source of information on the industry," *e.g.*, Rubin v. U.S. News & World Report, Inc., 271 F.3d 1305 at 1306-08 (11th Cir. 2001) (falsified books in jewelry industry).

the like—"Trust, but verify."[545]

Agency theory posits that where a person has his or her own money at stake, they will be more attentive. This is borne out in practice in large retail stores where even managers are loathe to "rat out" a thieving co-worker as opposed to managers of franchises whose income is tied to indices such as profitability and shortage control: those managers are more prone to fire an employee whose theft has an immediate impact on the manager's compensation. Internal control calculus is different for franchisees who are always at their business in contrast to franchisees who rely on managers to operate the business for all or a portion of the time during which the franchise is transacting revenue-generating business. This is because a franchisee not continuously on site will impose controls in order that the franchisee is able to deter and detect theft. Those same controls will often tend to operate to the benefit of the franchisor and the governmental tax authorities, since proper controls will create a paper trail and ensure that cash arrives at the depository which will retain an independent record of deposits. Where gross revenue is accurately recorded, the franchisee has an incentive to record all costs in order to minimize net (taxable) income. Purchases of raw materials are often governed by franchisor-mandated specifications as to approved vendors, providing yet another independent source from which Cost of Goods Sold (COGS) may be obtained. COGS and other expenditures expressed as a percentage of gross sales are then compared to franchisor national and regional comparable numbers in order to detect variances.[546]

There is a slope of diminishing returns when the cost of internal control and audit is placed against the revenue from internal control and audit. This slope is not only comprised of "hard" costs in dollars, but the "soft" costs of increased mistrust: franchisor lack of trust can induce

545. Kate O'Sullivan, *Trust, but verify*, INC. MAG., Apr. 1, 2001, *available at* http://www.inc.com/articles/hr/manage_emp/motivate_emp/22312.html (last visited May 18, 2003) (secret shoppers used for quality control at noodle shop chain). The phrase was popularized in the 1980's by President Ronald Reagan in his dealings with the Soviet Union and is taken from the Russian proverb "Doveryay, no proveryay." Gartner research, *Letter From the Editor*, Apr. 30, 2002 *available at*: http://www4.gartner.com/pages/story.php.id.2401.s.8.jsp. McDonalds makes significant use of secret shoppers and in April 2002 it was reported that the franchisor had already conducted 22,000 visits that year. Amy Zuber, *McD to Post 6th Quarterly Decline, Concedes Service Woes*, NATION'S RESTAURANT NEWS, Apr. 1, 2002, at 1.

546. Variances indicate not only royalty underreporting, but quality control problems. For example, a low COGS may indicate that the franchisee is skimping on raw materials, and selling the customer a product which is not up to franchisor standards. A low labor cost or high productivity number may be indicative of long customer wait times or employees rushing to assemble products of inferior workmanship.

untrustworthy behavior on the part of the franchisee.[547] Because of this, non-confrontational audit methods are favored by many franchisors—COGS, labor, and other expense data can be obtained independently, as can much revenue data such as units sold, credit card, and banking information. Point of Sale (POS) systems are set to capture and download this data to the franchisor via modem. In this paradigm, confrontation with the franchisee is disfavored; rather like Schrödinger's cat, all things exist in harmony until one peers inside the box.

But sometimes it is the franchisee who opens the box, and the franchisor response reveals much about how the franchisor views the relationship. Economist Ernest Fehr has shown that if a party refrains from exercising a valid right to fine a non-cooperating party, cooperation is enhanced in the future.[548] In a recent case known to this author, a franchisee derived significant revenue from sales to a major music television network. One time the network's accounting department accidentally sent a $2,500 check to the franchisor's corporate accounting department, which ascertained that the franchisee had not reported that sale and previous sales. The franchisor sent notice to all franchisees in the same county that it would be conducting a series of detailed random audits of surrounding franchisees. Although the franchisor did not explain the reason, franchisees quickly discovered the reason and the issue of underreporting and the consequences to all franchisees were widely, albeit quietly, discussed. Adopting the Fehr approach, the franchisor permitted the franchisee to restate revenues and warned that if any future underreporting occurred, a dozen franchisees in the offending county, chosen at random, would have a three-year audit with expense of the audit being charged to the franchisees. A representative of the franchisor explained to the authors that after review, the franchisor (one of the top 5 franchisors in the U.S.) deliberately chose to refrain from exercising maximum legal remedies in order to signal to franchisees that the franchisor was being more than fair to franchisees, and expected fairness and honesty in return. In the two years following the incident, the franchisor experienced rapid expansion in the county, rising numbers of multi-unit owners, and no litigation/arbitration claims from franchisees within the county.

Contrasting with the Fehr approach, the Dunkin' Donuts approach is one of publicly stated mistrust of and surveillance of franchisees. At a

547. *See*, Ken Grimes, *To Trust is Human*, NEW SCIENTIST, May 10, 2003, at 32, 36 (citing work of and quoting Ernst Fehr of the University of Zurich stating that subject is more likely to show trustworthiness when trusted by the other party).

548. *Play Fair, Why Don't You?*, NEW SCIENTIST, May 17, 2003, at 36, citing 422 NATURE 137 (2003), studies of Ernest Fehr, Institute for Empirical Research in Economics, Zurich.

meeting of the ABA Forum on Franchising in New Orleans, Stephen Horn, general counsel for Allied Domecq QSR (the parent of Dunkin' Donuts) discussed how Dunkin' spies on franchisees at their homes and work. In his written materials, Horn discusses "franchisee lifestyle . . . . Everyone knows which franchisee just built a beach house and which one drives a late model Mercedes."[549] To Horn, every franchisee is suspect: "[T]he franchisee who is happy and wants to expand. Has anyone checked to see how much he claims to earn from the business? . . . Of course, poor attitude may also bespeak a problem."[550] How to dig up the dirt? Horn's written materials are circumspect compared to his oral presentation, but instructive:

> One of the best ways to gather evidence . . . is to conduct surveillance of the franchise . . . . Investigators are fairly ingenious at figuring out ways to get the job done. Some are known to use small video cameras that can fit inside a briefcase . . . an investigator posing as a customer can shoot footage while eating on line or sitting at a table . . . an investigator can pose as a potential buyer if the franchisee has the business on the market.[551]

Horn's conclusion:

> The best use of surveillance is not necessarily to generate evidence for court, but to confirm that a franchisor's suspicions are correct and provide some ammunition for a confrontation meeting with the franchisee. If the case goes to court, the franchisor can always use subpoenas to gather all the evidence, of which surveillance will provide but a snapshot.[552]

At the conclusion of his presentation, Horn turned on a slide projector. He then regaled the assembled attorneys with photographs *not* of Dunkin' stores, *not* of Dunkin' franchisee deliveries, *not* of surveillance inside stores—rather, Horn showed photographs of the personal homes, boats, and cars of Dunkin' franchisees. Horn then made explicit to the attorneys what he meant by "ammunition for a confrontation meeting": the franchisee would be confronted with photos that the private investigator had taken while lurking around the family home. Dunkin' attorneys would point out that there was an "obey all laws" clause; the

549. Stephen Horn and Jeffery S. Haff, *Franchisee Nonpayment of Fees: Underreporting, "Royalty Strikes" and Related Issues*, *in* FRANCHISING WITHOUT BORDERS at Tab W9 at 3(2000 ABA Forum on Franchising).

550. *Id.*

551. *Id.* at 4. One Massachusetts attorney told this author that his client suspected that one of Dunkin's undercover spies was even dressed in military uniform.

552. *Id.* Footnote noted attorney Jeff Haff's comment that such behavior adversely affects franchisee morale and trust in their franchisor.

family appeared to be living beyond its means, and what would happen if the IRS got these photos? Under such circumstances, Horn stated, the franchisee would normally pay the Dunkin' demand.[553] Franchisees who fight Dunkin' risk exposure of their private lives, as Horn's slide show indicated; one franchisee subsequently said that Dunkin' even makes inquiries into franchisee's "romantic relations"[554] The threat of forfeiting a $500,000 investment and having one's "romantic relations" exposed provide a powerful weapon to ensure franchisee submission to franchisor demands.

After the panel finished presenting, several attendees gathered around the two presenters. Several asked Horn about his recent novel, and one for an autograph. None asked about the ethics of Dunkin's strategy. When this author asked if Dunkin's practices did not amount to extortion, Horn hastily said that he had been misunderstood. Some while later, this author had communication with three attorneys about Horn's presentation; two of the attorneys had attended the meeting. One of those who attended noted that his clients had told him about the Dunkin' surveillance, but that he was surprised that Dunkin' was so public about discussing such practices, as well as surprised at the lack of reaction from the attendees. One attorney who had not attended the presentation defended Dunkin' practice and said it was ethically permissible. That is debatable: an attorney who retired after working for a disciplinary committee in a major east coast state told the authors that the issue was clear-cut: threatening criminal prosecution (tax fraud) in order to gain advantage in a civil matter. The issue was not, she explained, how artfully the franchisor attorney skirted the letter of any ethics regulation: "he knows precisely what he is doing, why he is doing it, and he knows what the response of the other party will be. It's not even a close call in my mind. It's shocking to get up and boast; it makes you wonder what else they're up to."

Robert Zarco, one of the world's foremost franchisee attorneys,[555] takes up the Dunkin' story from this point. In 2002, Zarco says, Dunkin's suit for underreporting by Pittsburgh franchisee Chris Romanias was dismissed because the court did not find Dunkin's accounting methodology to be credible.[556] At the same time, Zarco's

553. Horn regarded the slide show as the pinnacle of his presentation, repeatedly noting how effective such photos were. When the projector initially did not work, a hotel employee was dispatched to fix the equipment and Horn noted how glad he was that the attendees had been able to see his slides.

554. Martin, *supra* note 148, at 111 (citing fall 2002 interview in BLOOMBERG MARKETS magazine).

555. Zarco won the *Scheck* case (U.S.) and *Hungry Jack's* (Australia). *See* www.zarcolaw.com.

556. Martin, *supra* note 148, at 111.

firm was representing Miami franchisee Omar Martinez in a similar suit.[557] After the Pittsburgh case, claims Zarco, the Dunkin' attorneys realized that they could not show any underreporting by Martinez, and indeed on January 3, 2003 Dunkin' dropped its underreporting claim against Martinez.[558] What remained was a claim for violation of the tax and employment laws.[559] The strategy outlined by Horn in New Orleans in 2000 had become the litigation strategy in Miami in 2003. The "violations" were not ones which damaged the franchisor; they were violations of federal law. Dunkin' did not allege that Dunkin' had lost any money, Dunkin' alleged that Martinez had cheated the IRS and had not always filled out the I-9 form of the Immigration & Naturalization service when he hired new employees.[560]

Large franchisors can legally avoid taxes on much of their income, and have multimillion-dollar lobbying efforts to ensure, for example, that states do not tax franchisor royalty revenue.[561] There is nothing illegal with franchisors getting the best tax code money can buy,[562] but franchisors have also violated the law when doing so enabled them to take advantage of the most vulnerable. Recall that many of the largest corporations in the country, including major franchisors such as Taco Bell and Wendy's, have been found guilty of violating employment laws and paying less than the legal wage.[563] The franchisor corporations paid fines, but did not forfeit their business as an additional penalty. Employees received back pay awards, but none of them wound up getting the company given to them. It should also be noted that an arbitrator who pleads guilty to a criminal tax charge may still render an award, since tax fraud has no effect on the integrity of the award.[564] One

557. Dunkin' Donuts Inc. v. Omar Martinez, 2003 WL 685875 (S.D. Fla. 2003).

558. *Id.* at n.2.

559. *Id.*

560. *Id.* at 2.

561. Jerry Wilkerson, *Franchising Likely To Grow as Recently Jobless Seek To Mind Their Businesses*, NATION'S RESTAURANT NEWS, May 26, 2003, at 27 (efforts by states to tax royalties deemed "a government obsession for dollars"). Companies can also do avoidance strategies such as placing their trademarks in a tax-free or low-tax jurisdiction and "charging" the parent company royalties, thus making income tax-free.

562. Like everyone else, franchisors don't like to pay taxes and have fought against paying taxes on income from franchisee royalties, AAMCO Transmissions, Inc. v. Taxation & Revenue Dep't, 600 P.2d 841 (N.M. 1979) (IFA *amicus* brief for franchisor), and lobbied against the estate tax, FISHER SCHUMACHER & ZUCKER, FRANCHISE ALERT, February 2001 (We have . . . lobbied . . . in support of repealing federal estate taxes). On IFA position, *see*, Paul Frumkin, *Industry Supports Federal Tax Cut Plans*, NATION'S RESTAURANT NEWS, May 26, 2003, at 1, 96 (quoting Don DeBolt on corporate dividends tax cut).

563. *Supra* note 329.

564. United Transportation Union v. Gateway Western Railway Co., 284 F.3d 710, 712 (7th Cir. 2002).

franchisor even *requires* that franchisees commingle business and personal tax items,[565] and the dependence of the foodservice industry and the rest of the U.S. economy on the 11 million undocumented workers has been the impetus behind efforts to legalize this essential economic force;[566] just a month before the World Trade Center attack changed views on immigration, the restaurant industry was supporting President Bush's efforts to legalize Mexican immigrants.[567] There is a bit of hypocrisy in the franchisor stance in *Martinez*.

In the case of Omar Martinez, tax evasion charges were brought not by the government, but by Dunkin' Donuts, after Dunkin' "subpoenaed numerous third-party financial institutions, the Social Security Administration, Defendants' accountant" and conducted various depositions.[568] The court found that Dunkin' had proven that Martinez "failed to comply with applicable tax laws" for 1999, 2000, and 2001.[569] Since this was not a tax fraud case, and since the I.R.S. was not the party

565. For example, Subway sandwich franchisees are required to purchase supplies through the Independent Purchasing Cooperative (IPC), an organization ostensibly independent of the franchisor. For liability reasons, franchisees often assign their operating rights to a corporate entity. Expenses and revenues are netted out and taxes paid (commonly but not always as an S corporation). The IPC sends an annual check for each store representing vendor rebates on business purchases. Disregarding the corporate form, the check is payable not to the corporate entity which purchased the items, but to a natural person. Hence, the franchise is making purchases which are deductible as business expenses on the business tax return and a portion of the expenditure is sent back (as income) to a natural person, the franchisee. This practice also places the franchisee at risk of those seeking to pierce the corporate veil. Subway franchisees are also required to keep available on-site 3 years of tax returns (business & personal) for perusal by franchisor representatives. Doctor's Associates, Inc. *Franchise Agreement*, *available in* SUBWAY FRANCHISE OFFERING CIRCULAR at Exhibit "A," p. 5 (1st ed. 2002).

566. Milford Prewitt, *Many Borders To Cross: Immigration Reform on Rocky Road*, NATION'S RESTAURANT NEWS, July 7, 2003 at 1, 49 (food industry workers overwhelmingly Latino), at 50 (Pakistani deli owners in Brooklyn), at 52 (rule rather than exception that undocumented workers staff high-end restaurants), *also*, John Moreno Gonzales, *Turning Blind Eyes: Illegals essential to work force, employers say*, NEWSDAY (Queens Edition), July 23, 2003 at A18, A36 (Government "fully aware" of illegals and that "the only way to retain this work force is to allow the new immigrants to work without papers"). The role of undocumented workers is widespread in the U.S., and in Freeport, N.Y. the village paid to set up a job hiring site to match workers with employers. Elissa Gootman, *Battling on 2 Fronts on L.I. Over Immigrant Job Centers*, N.Y. TIMES, Sept. 19, 2002, at B5.

567. Milford Prewitt, *Operators, Lobbyists Laud 'Alien' Amnesty*, NATION'S RESTAURANT NEWS, Aug. 13, 2001, at 1.

568. Dunkin' Donuts Inc. v. Omar Martinez, 2003 WL 685875 (S.D.Fla.), Feb. 21, 2003 at *1-2. The result may have been different if the subject franchise had been a gas station; the PMPA permits termination for "fraud or criminal misconduct by the franchisee relevant to the operation of the marketing premises." 15 U.S.C. § 2802(c)(1). Martinez' activities related to personal expenses deducted on a tax return, not to operation of the Dunkin' franchise itself.

569. *Martinez* at *5.

bringing the suit, the court did not assess any penalties to be paid to the I.R.S. or direct the payment of the taxes (presumably Dunkin' will forward the papers to the I.R.S. since Dunkin' conducted the tax audit).[570] The court rewarded Dunkin's assistance to the I.R.S. by forfeiting Omar Martinez' store to the franchisor on the grounds that the false statements Martinez made to the I.R.S. constituted a "material breach" of the franchise contract.[571] In support of its position, the court cited an additional three cases that Dunkin' had brought to terminate franchisees under the "obey all laws" clause.[572] The court gave short shrift to Omar Martinez' argument that he had neither been charged with nor admitted to tax fraud, holding that a franchisor "need only prove Defendants' violation of the law in order to enforce their contractual right to terminate."[573]

Dunkin' Donuts and Baskin Robbins are part of the Allied Domecq conglomerate.[574] Omar Martinez was "charged" by Allied Domecq with a handful of violations of federal law during the period 1999-2001, and Allied Domecq argued that Martinez should forfeit his business because of that. Conversely, Allied Domecq violated federal law *20,870 times* during 1994-1997, which violations enabled Allied Domecq to add net sales of $1,040,905.[575] And unlike Martinez, Allied Domecq's violations were directly related to business activity—indeed, the illegal activity was Domecq's business. Moreover, when the Treasury Department attempted to investigate Allied Domecq's violations of law, the records had disappeared: as one commentator noted, such action "implies evasion to conceal the involvement."[576] Allied Domecq paid the U.S. Government $260,000 as a fine for not obeying the law—less than the value of franchises forfeited to it under the "obey all laws" clauses. The publicly available records redact the mitigating circumstances paragraph, so it is not known whether Allied Domecq agreed to assist other Treasury Department investigations, but Allied Domecq subsequently "cooperated fully" with the I.R.S. in getting seven franchisees charged in the Boston

570. *Id.* at *12-13.
571. *Id.* at *9.
572. *Id.*
573. *Id.* at *10.
574. James Peters, *Dunkin'-Baskin-Togo's Parent Allied Domecq Lists Shares on NYSE*, NATION'S RESTAURANT NEWS, Aug. 19, 2002, at 4 (noting that only 10% of 2001 revenues of $4.2 billion came from restaurant division).
575. Memorandum of Betsy Sue Scott (Chief, Civil Penalties, U.S. Department of the Treasury) dated Oct. 3, 2001, *available at* www.ustreas.gov/foia/reading-room/docs/ofac-index.html (June 25, 2002 production, Image 2) (multiple violations of Cuban trade embargo, travel to Cuba, failure to retain records).
576. Christopher H. Johnson, *U.S. Foreign Trade Sanctions and the Multinational Corporation*, INTL. L. NEWS, Spring 2003 at 15, 16. The article refers to Allied "Comecq" [sic].

area alone.[577] In short: if a franchisee breaks federal law he loses his business, if a franchisor corporation breaks federal law it pays a (relatively) miniscule fine. The distinction here is that Martinez made improper deductions on his tax return, apparently a far more serious offense than Allied Domecq making a million dollars by doing business with a repressive dictatorship in violation of federal law.

Assuming that an individual or corporation violates federal law, that is a matter for the government. If Allied Domecq was auditing its franchisees out of some perceived civic duty to enforce the Internal Revenue Code, that would be odd but not illegal or unethical. And given Domecq's inability to uncover one of their own executive's theft and transfer of $15 million to tax-free offshore bank accounts,[578] their concern for a few off-the-books jelly doughnuts is arguably misplaced and Pittsburgh court was correct in questioning Domecq's auditing acumen. However, given the written and oral representations of Dunkin's counsel at an ABA seminar coupled with the circumstances of *Martinez*, serious questions are raised about the legality of Dunkin' tactics and the legal ethics of Dunkin' counsel. Even if Dunkin' now institutes a policy of mandating reporting to the I.R.S. of all Dunkin' compliance audits, Dunkin' can still accomplish its goals at the "confrontation meeting" by threatening to exercise Dunkin's contractual rights to have Dunkin's phalanx of tax auditors pore over the franchisee tax returns. Unless the franchisee is prepared to take the risk that there is nothing in all of the franchisee's business and personal tax returns that is open to question, and no embarrassing "romantic relations," it is not worth the risk of a spurned Dunkin' "cooperat[ing] fully" with the I.R.S. (not to mention a wrathful spouse). The issues raised by Dunkin's tactics go beyond the scope of this paper, but do illustrate the ability of franchisors to bring the resources of a multibillion-dollar conglomerate to bear in an ethically questionable manner in order to seize without payment the business of a franchisee.

IV. Post-Relationship Issues

A. Selling the Franchise

A franchisor can make life intolerable for a franchisee and push the

577. Martin, *supra* note 148.

578. Press Release, U.S. Dept. of Justice, Former Executive of Domecq Importers Inc. Charged With Conspiracy and Money Laundering (Mar. 30, 2002), *available at* http://www.usdoj.gov/opa/pr/2000/March/152at.htm. Three Domecq execs were implicated in the scheme uncovered during an antitrust investigation of Domecq and other companies.

franchisee to do as the franchisor demands or sell to a more malleable franchisee. This would not be a problem if the franchisee could sell the franchise freely. There is a bit of a *Scheck*-type debate among the courts on this issue: In *Taylor Equipment*, the Eighth Circuit (applying South Dakota law) declined to follow the *Larese* case out of the Tenth Circuit (applying Colorado law):

> [*Larese*] held that the implied covenant required that the franchisor not unreasonably withhold consent . . . [opining that] "the franchisor must bargain for a provision expressly granting the right to withhold consent unreasonably, to insure that the franchisee is put on notice." We disagree . . . we decline to follow *Larese* because it would impose an unrealistic drafting burden on parties who intend to create an unrestricted approval clause whose exercise will not be supplanted by a jury's notion of reasonableness.[579]

The Eighth Circuit missed the point of *Larese*, which is that a single line in the UFOC—similar to post-*Scheck* UFOC language regarding encroachment—would obviate juror notions of reasonableness. In any event, the franchisor must approve any prospective purchaser, and may retain right of first refusal, and is the primary source of prospect leads. In fact, since the franchisor controls the use of the franchise trademark, the franchisee may even be prohibited from placing a "For Sale" notice in the newspaper which advertises the name of the business for sale and the franchisee prohibited from placing "For Sale" signs on the premises of the franchised location itself. If the franchisee markets the franchise directly or through a business broker, the franchisor must still approve the purchaser. This means that the franchisor salesperson will have an opportunity to dissuade the prospective purchaser, and any tortuous interference claim will be difficult for the franchisee to prove if the salesman is subtle. The pool of prospective purchasers may be further limited in systems such as McDonald's[580] or Domino's Pizza[581] where the prospect must first be an employee for a year.

The franchisor both controls purchaser leads and grants/withholds franchise approval. The franchisor will have the opportunity to influence the prospective purchaser's offering price and choice of which franchise to purchase. In a less mature system, the franchisor can steer the franchisee to a new location. If the franchisor has embarked on a

579. Taylor Equipment, Inc. v. John Deere Co., 98 F.3d 1028, 1034 (8th Cir. 1996), (citing Larese v. Creamland Dairies, Inc., 767 F.2d 716, 718 (10th Cir. 1985)). *Taylor* was followed by the Fourth Circuit in Enfield Equipment Co., Inc. v. John Deere Co., 2000 U.S. App. LEXIS 17424 at *10 (4th Cir. 2000).

580. *See supra* note 356.

581. Rachide, *supra* note 446. Rachide notes he started as a 19 year old, "working my way up through the ranks . . . long before I ever heard of a UFOC."

program of re-franchising,[582] it may steer the prospect to a company owned store. Hence, a departing franchisee who spends money to advertise his business in the classifieds may be simply generating sales leads for the franchisor. A system in the throes of refranchising may put pressure on the sales staff to quickly dispose of company units; even franchisors concede that refranchising is a sign of economic uncertainty and a need to expand to compensate for stagnant sales.[583]

A franchise purchase consists of both intrinsic value and time value. A franchise is a wasting asset due to the finite term; unless the franchisor chooses to contractually obligate itself it is under no obligation to renew the franchise.[584] Most franchisees never consider an exit strategy when they enter the franchise system, and if they have not been franchisees, most will never realize that their exit price is greatly controlled by the franchisor. Given a choice between influencing the price in favor of the departing or arriving franchisee, it is logical for the franchisor to favor the arriving franchisee. As a condition of approving the transfer, a franchisor may even require a prospective purchaser to spend significant sums to remodel the site; an economically rational purchaser will reduce the price paid the franchisee by a corresponding amount.[585]

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582. Joel Holsinger, *Does Refranchising Make Sense?*, FRANCHISE TIMES, Aug. 2002, at 43 (in QSR segment alone, over last 7 years 7,600 units refranchised, raising $4.5 billion for franchisors). *See also*, Amy Spector, *Tricon Mounts Taco Bell Bailout: Store Buybacks, Debt Waivers Wyed as 'Refranchising' Criticized*, NATION'S RESTAURANT NEWS, Feb. 26, 2001, at 1 (Taco Bell raised $3.1 billion, reduced corporate outlets from 47% in 1994 to 20% in 2001. Franchisees paid excessively high prices; one lender reportedly took $350M write-down. *Id.* at 4. Also notes refranchising at Hardees, Carl Jr's, Coco's, Checker's, Church's Chicken, Popeye's, Cinnabon, Captain D's Seafood). *Id.* at 1-2. *See also*, *New World Bids To Buy Bankrupt Einstein/Noah Bagel for $181M*, NATION'S RESTAURANT NEWS, June 4, 2001, at 12 (New World refranchising to shift toward higher-margin manufacturing). *See generally*, Larry Simmons, *Achieving a Successful Refranchising Program*, FRANCHISE TIMES, June-July 2001, at 44-5.

583. Lori Doss, *Ground Round To Refranchise from 112-Unit Holdings*, NATION'S RESTAURANT NEWS, Nov. 12, 2001, at 8 (quoting IFA President Don DeBolt). When PepsiCo spun off Tricon, the franchisor had $4.5B in debt; refranchising brought in $2B. *Diageo: 915 International Units Would Go To BK Corp. To Trim Debt Costs if it Does IPO*, NATION'S RESTAURANT NEWS, Aug. 6, 2001, at 6. A short while later, many of Tricon's refranchised stores verged on bankruptcy. In the Ranch 1 Chicken chain, stores were sold off to franchisees to pay down debt after top executives of the franchisor were linked to a stock fraud involving organized crime (the company itself was not implicated). *Fowl Play for Cash*, CRAIN'S N.Y. BUS., June 18, 2001, at 6.

584. Zuckerman v. McDonald's Corp., 35 F.Supp. 2d 135, 143 (D. Mass. 1999).

585. The authors are informed by one franchisee that after purchasing from a retiring franchisee, the new franchisee was told during his monthly compliance review that he would be required to perform remodeling and upgrades estimated at $20,000. The retiring franchisee was friends with the area master franchise developer. Normally, the franchisor would inform the incoming franchisee of the immanent expenditures, resulting in a reduced price. *See id.* at 146 (McDonald's intended to require purchaser to remodel, Seller reduced price).

The net effect of franchisor power, one commentator has noted, is that "the franchisor may force the price below market value, thus easing the task of marketing the franchise at the expense of the departing franchisee."[586] In addition, the departing franchisee will not tell the truth to the incoming franchisee—at least, not if the departing franchisee wishes to consummate the sale. If the new franchisee seeks to bring suit, the franchisor can point to the integration clause and the interest of the new franchisee in maintaining good relations with the franchisor. Moreover, the franchisor has likely relied on the exiting franchisee to make explicit representations as to the strength and profitability of the outlet and the system in general; the franchisor then protects itself by having the incoming franchisee attest that the franchisee has not received such representations from the franchisor.

Although the franchisee's sale of the business to a new owner is contingent upon franchisor approval, the converse is not true. A franchisor may sell the company to another purchaser who may have radically different ideas for the brand. Baskin Robbins was a respected franchisor prior to its purchase by Allied Domecq. Franchisee Jerry Merrill observed that the managers at Domecq "don't care one iota about the people who devoted their lives to building this [Baskin Robbins] brand."[587] Allied Domecq announced that it deemed 140 locations as "non-strategic" locations which would not have their franchise agreements renewed. Even worse, franchisees had a non-compete clause in their agreement, and Domecq's spokeswoman warned that Allied Domecq "does not condone the actions of franchises who [sic] have left the system before the completion of their franchise agreements and opened under another brand."[588] Jerry Merrill wanted to rebrand his first outlet when the contract expired and Domecq refused to renew. But Domecq refused to waive the non-compete clause because, Merrill noted, they still held the lease on the franchisee's second outlet and wanted to extract the maximum value from the outlet prior to the second contract's expiration.[589]

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586. SULLIVAN & GRIMES, *supra* note 258, at § 8.2c2ii. Again, this is in distinction to an analogous situation in the securites marketplace, where a majority stockholder owes fiduciary duties to the minority stockholder in a transaction which pushes out the minority holder, *In re* Pure Res., Inc., Shareholders Litig., 808 A.2d 421, 444 (Del. Ch. 2002).

587. Julie Bennett, *'Non-Strategic' Franchisees Form New Brand*, FRANCHISE TIMES, June/July 2002 at 18.

588. *Id.* at 19.

589. *Id.*, quoting Jerry Merrill. Ultimately, the terminations involved about 200 agreements, and a group of former Baskin franchisees reorganized as the KaleidoScoops cooperative, Carolyn Walkup, *Frozen-out franchisees regroup with KaleidoScoops*, NATION'S RESTAURANT NEWS, July 7, 2003 at 8. Initially sales declined 20% but partially recovered over time. *Id.*

B. Franchise "Renewal"

The franchisor may perceive a benefit to recruiting franchisees with unrealistically high expectations. The type of cognitive dissonance known as disconfirmed expectancies suggests that a franchisee entering the relationship with unrealistically high expectations of ability to succeed will work harder when confronted with the low pay and long hours common to franchising.[590] The franchisee may continue to experience negative cash flow for an extended period,[591] depleting his resources for the benefit of the franchisor:

> [D]uring the first years of their agreement, most franchisees think things are going great. The realization that they are trapped does not occur until they are forced to sign the renewal contract. Many franchisees are shocked to learn that the assets of their business are barely worth enough to pay off the liabilities. At least by signing the [renewal] agreement they are able to keep their job.[592]

A distinction between *Bolter* and *Casarotto* raises another problem found in franchise contracts. The arbitration clause in *Casarotto* was in the initial agreement, in *Bolter* the clause at issue was in a subsequent agreement. Franchise agreements are for a term of years, and:

> [A] franchise agreement is subject to the vicissitudes of the market. Advances in the art or in technology, competition of other processes, [and] consumer preferences, all place practical limitations on the duration of most franchises.[593]

What franchisees may not expect is that the franchisor may make changes not to respond to market conditions but to take opportunistic advantage of the franchisee's sunk costs. Dale Cantone of the Maryland Attorney General's office observes that "regulators have no jurisdiction over renewals and often that's worse than the original [contract]. You've already got a lot invested in the system, so there's usually less room for

590. Judith Evans, *Take a Good Look Before You Leap*, WASHINGTON POST, June 27, 1999, at H8. When reprinted in the CINCINNATI ENQUIRER, this article bore the more accurate title: ***Do Your Homework When Buying A Franchise: Long hours, modest pay may await***, Sunday July 18, 1999 *available at* www.enquirer.com/editions/1997/07/18/fin_do_your_homework.html visited 1/24/01. *Cf.* Elliot Aronson and J. Merrill Carlsmith, *Performance Expectancy as a Determinant of Actual Performance*, 65 JOURNAL OF ABNORMAL AND SOCIAL PSYCHOLOGY 178 (1962). Of course, the response makes sense in that (1) the perceived reward is larger than actually the case and (2) self-perception attributes failure as a personal and not a systemic shortcoming.

591. *Franchising Relationship, supra* note 49, at 33 (1999) (AFA survey showed only 41% of franchisees break-even first year, 19.8% of those surveyed never broke even).

592. Rachide, *supra* note 446.

593. Lichnovsky v. Ziebart International Corp., 324 NW 2d 732 (Mich. 1982).

negotiations."[594]

At the expiration of the term, the franchisee who is unwilling or unable to continue the franchise may find that all the years of hard work become the property of the franchisor and the franchisee is prohibited from working in the same type of business; a prohibition which the franchisor may interpret broadly.[595] Sunk costs and non-compete provisions may leave the franchisee little choice but to "renew" the franchise agreement: "the veteran franchisee who has spent 15 or 20 years building a business . . . either accept[s] these new terms or goes out of business."[596] Franchisors will assure prospects that they have the right to renew the franchise, and assure legislators that there is no problem: "Empirically, renewal is the norm . . . 93% [of 12999 agreements in sample] were renewed."[597] The truth of that statement depends on what the meaning of "renew" is.

A standard dictionary defines "renew":

> (1) To make new or as if new again; restore. (2) To take up again; resume. (3) To repeat so as to reaffirm: *renew a promise.* (4) To arrange for the extension of: *renew a contract.* [italics in original].[598]

A legal dictionary defines "renewal":

> (1) The act of restoring or reestablishing. (2) The re-creation of a legal relationship or the replacement of an old contract with a new contract, as opposed to the mere extension of a previous relationship or contract. [emphasis added].[599]

Franchise prospects are rarely lexicographers or attorneys. It is unlikely that Florence Bolter or any franchisee is aware of the fact that "renewal" in legalese means the *opposite* of what "renewal" means to a non-lawyer. When the FTC broached the issue of whether "renewal" was the most

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594. Nancy Weingartner, *AAFD celebrates 10 years in style*, FRANCHISE TIMES, Aug. 2002 at 7, 8.

595. Pizza Pizza Ltd. v. Gillespie, [1990], 1990 Ont. C.J. LEXIS 415 (Pizza franchisor maintained that exec who left to found chicken franchisor was in violation of noncompete, also in violation for use of "30-minute or free" delivery program. Court held for exec, noted that while he may have "developed his know-how" once he left pizza company "it had become personal to him as part of his intellectual make-up." *Id.* at *39.).

596. Letter of Malcolm Lindy, Popeye's Chicken franchisee, to Editor, NATION'S RESTAURANT NEWS, July 24, 2000 at 53.

597. Francine Lafontaine & Darrell L. Williams, Issues in the Economics of Franchising 5 (March 30, 2001) (presented at the ABA Antitrust Section Spring Meeting).

598. AMERICAN HERITAGE DICTIONARY 698 (3rd ed. 1994).

599. BLACK'S LAW DICTIONARY 538 (Pocket ed. 1996).

accurate term, one franchisor responded: "This term "renewal" is synonymous with franchising and we cannot ever recall when it was perceived as a misleading term."[600] Another group responded that while the term "seldom reflects what actually happens . . . [renewal] is an accepted term of art in franchising."[601] Tortured parsing, where plain English words are reversed to become legal terms of art, provides courtroom cover but tarnishes both franchising and the legal profession.

Franchisor sales agents should be prohibited from using the word "renewal" when they actually mean, "sign a new contract which may be completely different and take away rights you currently have as well as increase your obligations to us and diminish the value of your business." Chem-Dry (the franchisor in *Bolter*) tells prospective franchisees that it bases the franchise relationship on the question: "This may be legal, but is it ethical?"[602] Franchisor ethics are significantly different pre-contract than post, and franchisees should know that the law dictionary does not contain a definition for "disingenuous": that definition is found in the layman's dictionary on the same page as "dishonorable." Declining to renew a franchise can be a mechanism for a franchisor to capture the goodwill built up by the franchisee. With a few exceptions,[603] this is permissible. Only Hawaii takes note of the transfer of goodwill from franchisee to the non-renewing franchisor.[604] Failure to renew can bring wealth to the franchisor, but not to the franchisee:

> McDonald's Corporation began a de-franchise process as we were approaching the end of our 20 year lease. After working for ourselves for the better part of our lives, at the ages of 52 and 53 we were suddenly looking for employment. We sacrificed a big portion of our lives, so we could have something when we retired. Our current financial condition is that we will have to continue working in order to exist. It is very depressing to learn that what one has worked for is gone.[605]

600. Letter of NaturaLawn of America to Federal Trade Comm'n. (Dec. 22, 1999) *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/comment026.htm.

601. Letter of John R.F. Baer, Robert T. Joseph & Alan H. Silberman to Sec'y, FTC (Dec. 21, 1999) *available at* www.ftc.gov/bcp/rulemaking/franchise/comments/comment011.htm.

602. *ChemDry*, *supra* note 122.

603. California (Cal. Bus. & Prof. Code § 20025) and Minnesota (Minn. Stat. § 80C 14 subd. 4).

604. Hawaii (Haw. Rev. Stat. § 482E-6(3)) requires compensation, *including* for goodwill.

605. Letter of Joan Fiore to FTC (Undated), *available at* www.ftc.gov/bcp/franchise/comments/final61.htm.

C. *Goodwill*

One court noted that a franchise fee may be, in effect, a payment for goodwill.[606] The reality is that many franchises are simply a limited right to use a trademark[607] and a transfer of wealth from franchisee to franchisor.[608] Unlike a typical business whose goodwill increases the wealth of the *owner*, a franchised business develops goodwill that increases the wealth of the *franchisor*. An example of this is the Swinton Insurance franchisor in Great Britain. Founded in 1957, Swinton began franchising in 1984, and by the early 1990s it had 142 franchisees serving 1.5 million customers and Sun Alliance Group had purchased Swinton for about £ 250 million.[609] A Swinton brochure told prospects: "As your business increases, the value of your Swinton franchise will also increase . . . . When you retire or for any reason wish to sell, then you will reap the benefits of the equity you have built."[610] A Swinton analysis showed that the company could profit by over £ 4 million in five years by refusing to renew franchises, and at the 1997 franchisee conference, Swinton told franchisees that it would not renew their franchise agreements.[611] In asking the court to order renewal, the franchisees noted that while the franchisor was "acquiring a valuable asset from the franchisee," the franchisee faced "difficulty . . . in starting up his own business because the goodwill which [he] built up is not [his] own goodwill but that associated with the [franchisor] name."[612]

A franchisor entering a new market can use the resources of the franchisee to create the goodwill and then take away the right to use the trademarks once they have acquired value in the expansion market:

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606. Re: Floan and Copperart Pty Ltd, (Fed. Ct. New South Wales Dist., Slip Opinion at ¶ 56, Aug. 9, 1990), *available at*, LEXIS, Commonwealth & Irish Cases Combined File.

607. *See*, Piercing Pagoda, Inc. v. Hoffner, 351 A.2d 207, 211 (Pa. 1976) ("In its simplest terms, a franchise is a license from the owner of a trademark or trade name permitting another to sell a product or service under the name or mark."). Trademark rights may continue indefinitely. Kohler Co. v. Moen Inc., 12 F.3d 632, 637 (7th Cir. 1993).

608. In theory, the franchisor's knowledge of the ability to maximize the wealth transfer by opportunism during the franchise relationship should increase the value of the contract to the franchisor. *See* Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1267 (1980). A franchisor can set a low initial entry fee and target less-qualified prospects, with the knowledge that the contract's true value lies in the franchise relationship as it will become, not as the franchise relationship is at the time of contract.

609. Paperlight Ltd and others v. Swinton Group Ltd, Queen's Bench Division (Commercial Court), Hearing Transcript of Aug. 5, 1998.

610. *Id.*

611. *Id.*

612. *Id.*

> [I]t matters little to the franchisor whether a particular franchisee remains in business, as there will always be another franchisee available to take that place . . . . Once a franchisee has succeeded, through the expenditure of his own efforts and capital, to establish a local reputation for the franchise name, his franchise is vulnerable to termination.[613]

When Burger King Corp. (BKC) decided to establish a presence in Australia, it entered into a franchise agreement with a local company. After 20 years, BKC decided to take control of the market. The plan was described by the judge as "one of sinister simplicity"[614] in which "BKC's wholly discreditable conduct"[615] included the "commercially reprehensible"[616] practice of secretly obtaining information from the franchisee's employee which Burger King used "to formulate its strategy against [the franchisee] . . . in gross dereliction of the fiduciary duties I am satisfied BKC owed [the franchisee]."[617] The court found that "very senior officials of BKC" communicated with the franchisee "in terms which lacked frankness and veracity."[618] Burger King officials dissuaded the franchisee from dealing with Mobil on the basis of ongoing discussions with Shell for the establishment of Burger King outlets at gas stations, but lied to the franchisee about Burger King's true plans (to cut out the franchisee), a practice the judge found "further evidence of the commercially disgraceful way in which, in my opinion, BKC was conducting itself in relation to [the franchisee]."[619] Burger King also followed practices known to many franchisees: using punitive reviews and preventing the franchisee from meeting development targets and curing alleged breaches of the franchise agreement. In awarding $A 69,329,800 to the franchisee, the judge ruled "the overwhelming evidence is that BKC did not act with good faith . . . . It was determined to create a situation which would enable it to terminate [the franchisee]."[620]

Goodwill in the franchise relationship is a particularly controversial topic in France, where the right to receive the goodwill (*fonds de commerce*) of a franchise operation can have significant tax and real

613. General Motors Corp. v. Gallo GMC Truck Sales, 711 F.Supp. 810, 814 (D.N.J. 1989).
614. Hungry Jack's Pty Ltd v. Burger King Corp, NSWSC 1029 (1999), 1999 NSW LEXIS 61 (Sup. Ct. of New South Wales, Equity Division, Commercial List) at *271.
615. *Id.* at *248.
616. *Id.* at *243.
617. *Id.* at *244.
618. *Id.* at *248.
619. *Id.* at *241.
620. *Id.* at *489.

estate consequences.[621] American franchisees would be surprised to learn that a French franchisee/lessee of the business location has a right to automatic lease renewal if the franchisee is deemed the legal owner of the goodwill.[622] In California, a franchisor claimed to be the "owner" of the business and hence entitled to payment for goodwill under the state's Eminent Domain law; the court rejected the claim.[623] The link between locational (geographic) goodwill and lease renewal is not unique to France: Franchisee sub lessee protection was formerly granted under Brazilian law, but franchisors have succeeded in eliminating that protection,[624] with one franchise attorney making the incredible statement that:

> In view of the nature of franchising, the usual protection afforded by ordinary leases may not be appropriate . . . .
>
> In franchising, both parties are working with the common aim of making the franchise succeed, and there is no value in regulating their relationship under the Leasehold Law.[625]

Shortly after that statement was made, the Associated Press reported that McDonalds franchisees in Brazil are suing McDonalds, alleging, *inter alia*, that McDonalds pays 5% of sales as gross rent to the landlord but charges the franchisee 21% of sales, in violation of law—perhaps there *is* a value in regulating the relationship.[626] Just as franchisors claim exemption from the laws applicable to everyone else in testimony before American legislators, so too have franchisors in Brazil claimed—successfully—that they merit an exception to the law.

"Success" in the franchise context depends on perspective: franchisors normally take a percentage of the gross;[627] franchisees' profit

621. Rémi Delforge, *New Trends in French Case Law: The Growing Recognition of the Independence of Franchisees*, 2 INT'L J. OF FRANCHISING & DISTRIBUTION L. 37, 42-43 (2000). Also, franchisors are exempt from compliance with Article 85(3) of the EU Treaty "to the extent necessary to protect the identity and goodwill of a franchise chain," Phillippe Xavier-Bender, *European and French Law on Distributing Products*, 10-AUT INT'L L. PRACTICUM 61, 63 (1997) (NY State Bar Assn.).

622. *Id. at* 42 (citing Decree of September 30, 1953).

623. Redevelopment Agency of the City of Concord v. Int'l House of Pancakes, Inc., 12 Cal. Rptr. 2d 358 (Cal. Ct. App. 1992).

624. Cândida Ribeiro Caffé, *Recent Developments of* [sic] *Franchising in Brazil*, 2 INT'L J. OF FRANCHISING & DISTRIBUTION L. 159, 164 (2000).

625. *Id.* at 164.

626. CCH, BUSINESS FRANCHISE GUIDE NO. 266, ISSUE NO. 269, Dec. 21, 2001 at 12, citing Associated Press story of Dec. 10, 2001 (this section of the BFG is a pamphlet enclosed with the monthly update).

627. This can be direct, as in a stated percentage of gross revenues. It can be indirect, as in mandatory purchase of raw materials from the franchisor, on which the franchisor makes a profit. In either event, the practical effect is the same.

is the net. Perhaps franchisors behave differently in Brazil than in the United States. In the United States, a "successful" franchisee is often not even the lessee of his business premises[628] but a sub lessee[629] at the mercy of both the franchisor lessee and the landlord.[630] The importance of this provision cannot be overstated: it permits *de facto* unilateral termination of the franchisee, even if the franchisor deliberately acts in bad faith to seek termination of the lease in order to get rid of the franchisee. One court held, in refusing to permit such behavior, that a franchisee:

> [K]nows that his good service will in many instances produce regular customers. He also realizes, however, that much of his trade will be attracted because [the location] offers the products, services, and promotions of the well-established and well-displayed name [of the franchisor]. Unlike a tenant pursuing his own interests while occupying a landlord's property, a franchisee . . . builds the goodwill of both his own business and [the franchisor].
>
> In exchange, [the franchisee] can justifiably expect that his time, effort, and other investments promoting the goodwill of [the franchisor] will not be destroyed as a result of [the franchisor's] arbitrary decision to terminate their franchise relationship.

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628. *See generally*, Rick Kalisher, *To sign or not to sign, that's the franchisor's question*, FRANCHISE TIMES, Oct. 2001 at 55 (pros and cons of subleasing vs. direct lease between landlord & franchisee).

629. Franchise statutes generally do not apply to the relationship with a landlord, absent "an extraordinary situation." Bsales v. Texaco, Inc., 516 F. Supp. 655, 661 (DC NJ 1981) 1980-1983 BFG ¶ 7717. (Franchisees alleged franchisor and landlord colluded to not renew lease, resulting in termination of franchise agreement, thereby violating statutory protection of PMPA). *See* 15 U.S.C. § 2802(c)(4) (1997) (nonrenewal of gas station lease as grounds for franchise termination). On a more mundane note, as observed by this author, the lack of privity between franchisee and landlord gives the franchisor-lessee great control over even minor matters: the franchisee may require the intervention of the franchisor to fix a leaky roof.

630. Alignment of interests between franchisor and landlord may operate to the detriment of the franchisee, particularly where the landlord and franchisor have existing or potential contractual relationships to which the sub lessee (franchisee) is not a party. *Bsales*, note 7 at 663 (franchisee sub lessee had no rights in negotiations between landlord and franchisor master lessee). Franchisors may even take affirmative steps to prevent automatic renewal of the lease, thereby triggering franchisee termination. Veracka v. Shell Oil Co., 655 F.2d 445, 448 (1st Cir. 1981) 1980-1983 BFG ¶ 7576 (DC Mass), ¶ 7681 (*aff'd*). Another example is a situation where a landlord owned multiple properties suitable for franchise locations: the franchisor could negotiate a supracompetitive price on a franchisee-operated site in exchange for a below-market rate on a franchisor-operated site. There may also be the potential for kickbacks to the franchisor from the landlord or real estate agent with concomitant supracompetitive lease pricing to the franchisee. The cases cited were decided under the Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801-2806 (1997), which provides more protection than given to franchisees not covered by the PMPA or Auto Dealers Day in Court Act.

> Consistent with these reasonable expectations, and [franchisor's] obligation to deal with its franchisees in good faith and in a commercially reasonable manner [citation omitted] [franchisor] cannot arbitrarily sever its franchise relationship . . . . A contrary conclusion would allow [franchisor] to reap the benefits of its franchisees' efforts in promoting the goodwill of its name without regard for the franchisees' interests.[631]

It is true that a franchisor is normally in a better financial position than a franchisee, and a landlord may consent to a sublease in circumstances where a lease assignment would be refused due to the franchisee's more precarious financial position.[632] However, a franchisee might reasonably assume that if the master lease contained an automatic renewal option, the franchisor would exercise the option at the franchisee's demand, thereby preserving the franchisee's investment. The franchisee would find out that: (1) most courts disagree,[633] and (2) franchisor abuse of the lease relationship made it necessary for Congress to pass an amendment[634] to the PMPA to overrule case law and require petroleum franchisors to grant franchisees a right of first refusal on lease renewal options. Although this reduced the risk for petroleum franchisees,[635] it does not help non-petroleum franchisees.[636] Even where the franchise agreement is for a term of years, and theoretically the franchisee could relocate to another site, build-out expense[637] may be economically impractical or even impossible. As a practical matter, a franchisee in such circumstances could lose more than his entire investment[638] and not even reap the tax benefits of the unused depreciation. Alternatively, a franchisee who perceives the need to

631. Atlantic Richfield Co. v. Razumic, 390 A.2d 736, 742 (Pa. 1978). It must be stressed that courts and the law are more protective of franchisees who own gas stations than would be the case for franchisees who own, say, a doughnut shop.

632. *E.g.*, Ponderosa Int'l. Development Inc. v. Pengap Secs. (Bristol) Ltd, 277 EG 1252, 1 EGLR 66 (Chancery Div. 1986) (Landlord's refusal to permit assignment to restaurant franchisee while permitting sublease to franchisee was not unreasonable; both parties' experts testified that investors would view assignment as impacting value of building.).

633. 39 A.L.R. 4th 824 § 3 (courts in agreement that sub lessee normally cannot force exercise of renewal option).

634. PL 103-371 (1994 HR 1520), *codified at* 15 U.S.C. 2802(c)(4).

635. Hazara Enters., Inc. v. Motiva Enters. LLC, 126 F. Supp. 2d 1365, 1371 (S.D. Fla 2000) BFG ¶ 12,037.

636. Even for franchisees covered by PMPA, there is still room for franchisor action, PDV Midwest Refining LLC v. Armada Oil and Gas Co. Inc., 116 F. Supp. 2d 835, 847-848 (Franchisor's voluntary "loss" of trademark could constitute grounds for franchisee termination under PMPA notwithstanding 1994 amendments to PMPA.).

637. Franchisor estimates of buildout costs are in Item 7 of the UFOC.

638. For example, the remaining term on an equipment lease or deficiencies on secured debt.

relocate may need the permission of the franchisor, and in a mature franchise system, relocation may raise encroachment claims by franchisees in the impacted (relocation) area. The legislative history of the PMPA finds that:

> the franchise relationship in the petroleum industry is unusual, in fact perhaps unique, in that the franchisor commonly not only grants a trademark license but often controls, and leases to the franchisee, the real estate premises used by the franchisee. In addition the franchisor almost always is the primary, even exclusive, supplier of the franchisee's principal sale item . . . this relationship is . . . often complex and characterized by at times competing interests.[639]

The arrangement described, however, is no longer unique. Many franchisors are the master lessee and sublease the franchise site to the franchisee.[640] As a result, they are able to require the franchisee to arbitrate any disputes in private arbitration thousands of miles from the franchisee while suing on the lease in local court. In *Doctor's Associates, Inc. v. Stuart*, Subway franchisees alleged that the franchisor falsely claimed that arbitration was a condition precedent to legal action by either the franchisor or the franchisees.[641] The franchisor had a wholly-owned subsidiary which leased the store and then subleased to the franchisees.[642] The Subway store lease did not contain any arbitration provision.[643] In upholding the right of the franchisor to terminate the sublease due to a breach of the franchise agreement notwithstanding the alleged representations, the court was not bothered by the claimed franchisor fraud since the franchisees had notice of the provisions.[644] As one attorney observed: "It may be that the drafting gambit at issue in the case is familiar to counsel who frequently work in the franchise area, but I suspect that many transactional lawyers, including those with significant experience, would not spot the implications of those provisions."[645]

The goodwill "disposition of a pleased customer to return to the place where he has been well treated"[646] (*locational* goodwill) is created

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639. S. REP. NO. 95-731 (1978), *reprinted in* 1978 U.S.C.A. 873 at 875.

640. For example, the franchisor of the 17,000 unit Subway sandwich chain. McDonald's derives an estimated $1.5 billion from real estate operations. *See* Amy Zuber, *McD Layoffs 'likely' as fast-food giant slows expansion, focuses on rollouts*, NATION'S RESTAURANT NEWS, Nov. 4, 2002 at 4, 79.

641. Doctor's Assocs, Inc. v. Stuart, 85 F.3d 975, 979 (2d Cir. 1996).

642. *Id.* at 978.

643. *Id.*

644. *Id.* at 980.

645. Royce de R. Barondes, *The Business Lawyer as Terrorist Transaction Cost Engineer*, 69 FORDHAM L. REV. 31, 68 (2000).

646. Schwegmann Bros. Giant Super Markets v. Eli Lilly Co., 205 F.2d 788, 797 (5th

entirely by the franchisee and is captured by the franchisor when the franchisee exits the system.[647] At the expiration of the franchise agreement, the franchisor can capture two decades or more of goodwill. Joan Fiore, a McDonald's franchisee from New York, stated that when the twenty year contracts expired, McDonald's forced the Fiores to sell their stores at reduced prices to "new, younger franchisee[s]" and observed: "Had we spent twenty years as a [sic] janitor with a pension, we should have found ourselves in a far better financial position."[648] In one of the rare cases where a terminated franchisee was permitted to retain the leased premises, a Canadian court ruled:

> Given the failings of [the franchisor] and the hard work of [the franchisees] to become associated with [the] location, it would constitute unjust enrichment for [the franchisor] to regain control of those premises, cause the eviction of [the franchisees] and obtain for itself whatever locational goodwill may have been built up over the years . . . . The landlord . . . is content to have [the franchisees] as its tenant. Accordingly, there will be a declaration of constructive trust.[649]

Some franchisors such as Dunkin' Donuts reduce risk by demanding that the franchisee lease the premises but contractually agree to turn over the lease to the franchisor upon termination, on the grounds that "an inability to preserve the goodwill already accumulated at the location" will irreparably harm the franchisor.[650] Even if the franchisee is the lessee or owner of the property where the franchise is located, non-compete covenants will prevent the franchisee from retaining the

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Cir, 1953) (Holmes, C.J., dissenting). The classic definition of locational goodwill is: "nothing more than the probability, that the old customers will resort to the same place." Cruttwell v. Lye, 34 Eng. Rep. 129, 134 (1810).

647. *But see* Hutchens v. Eli Roberts Oil Co., 838 F.2d 1138, 1142 (11th Cir. 1988) 1987-1989 BFG ¶ 9085 (dicta suggesting that if franchisor had attempted to terminate franchisee to capture franchisee's goodwill court would have ruled in favor of franchisee under PMPA). *Also note:* The Southland (7-Eleven) franchisee leases everything from the franchisor. A buyer pays (1) a purchase price classified as goodwill the old franchisee and (2) a fee to Southland, discussion of the structure *in* Southland Corp. v. Froelich, 41 F.Supp. 2d 227, 241 (1999).

648. Letter from Joan Fiore to Secretary, Fed. Trade Commn., *available at* http://www.ftc.gov/bcp/franchise/comments/final61.htm. Phone comment of Joan Fiore *available at* http://www.ftc.gov/bcp/franchise/comments/fiori66.htm, case at BFG ¶¶ 10,963, 10,876 (D.C.N.Y. 1996).

649. Magnetic Mktg. Ltd. v. Print Three Franchising Corp., 38 C.P.R. (3d) 540, 565 (B.C. Sup. Ct. 1991).

650. Dunkin' Donuts Inc. v. Taseski, 47 F. Supp.2d 867, 878 (E.D. Mich. 1999), citing, *inter alia*, Dunkin' Donuts, Inc. v. Dowco, Inc., 1998 U.S. Dist. LEXIS 4526 (N.D.N.Y. 1998). A non-compete covenant survives the termination and even the bankruptcy of the franchisee: not only does the franchisee lose the goodwill at a particular site, but within the specified market radius as well.

goodwill the franchisee has built. The "Lick-a-Chick" franchisor provided that the franchise agreement was in perpetuity.[651] The agreement provided that if a franchisee-owner of the land and building where the franchise was conducted ever left the system, the franchisor had the right to purchase at original cost less depreciation.[652]

The unscrupulous franchisor has an incentive to capture the goodwill directly (by pushing the franchisee out or refusing to renew the franchise agreement) or indirectly (by encroachment or company-owned alternate channels of distribution). Accepting the IFA's testimony in Congress that franchising is a "partnership,"[653] we are reminded of Judge Cardozo's observation:

> To say that a partner is free without restriction to buy in the reversion of the property where the business is conducted is to say in effect that he may strip the good will of its chief element of value, since good will is largely dependent upon continuity of possession.[654]

Geographic goodwill can extend into cyberspace. The Internet, Federal Express, and dry ice have combined to make virtually any product[655] eligible for worldwide delivery by the franchisor (who has superior rights to the franchise domain name[656]) at the expense of local "brick and mortar" franchisees: the franchisees may become a showroom network funneling business to the franchisor web site. In such a case, the franchisor benefits from patronage by customers who would not shop on an Internet site but for the presence of the local franchisee.

Even without Internet distribution, the corporate franchisor can capture the goodwill of the small business who got the customer in the first place. The nature of a franchise/dealership agreement is such that the upfront costs of acquiring the customer may be borne by the small

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651. A&K Lick-a-Chick Franchises Ltd. v. Cordiv Enters. Ltd., [1981] 56 C.P.R.2d 1.

652. *Id.* The court found the agreement terminable on reasonable notice and refused to enforce the sale of premises to the franchisor, dismissing franchisor arguments that the contract was entered into voluntarily and that the franchisee had chosen not to seek legal advice.

653. Testimony of Adler, *infra* note 993. As a matter of law, franchising is not a partnership. Since IFA counsel Matthew Shay was deeply involved in the above testimony, this fact is presumably known to the IFA.

654. Meinhard v. Salmon, 249 N.Y. 458, 467 (1928) (Cardozo, C.J.) citing Matter of Brown, 242 N.Y. 1, 7 (1926) (Cardozo, J.).

655. *See*, Pooja Bhatia & Edward Felsenthal, *When Pigs Fly*, WALL ST. J., August 3, 2001, at W1 (estimate 10 million pounds of barbeque-by-mail in 2001, more than double volume of three years ago).

656. Anti-Cybersquatting Consumer Protection Act of 1999 15 U.S.C. § 1129, addressing "problems faced by owners of famous marks when dealing with the issue of domain names." H.R. REP. NO. 106-412, at 5.

business, but the gains accrue to the corporate giant. A Cingular Wireless dealer brought suit after one of his customers brought him a taped message in which Cingular told the customer of a special free phone promotion.[657] Cingular specifically told the customer not to go into the dealer's store, the promotion was only available from Cingular; and when customers switched the dealer's residuals were terminated.[658] The dealer also alleged that Cingular induced him to only deal Cingular products with the assurance that the dealer would have access to the same promotions and pricing, but Cingular's own stores and direct telemarketers then undercut the dealer.[659] Häagen-Dasz referred to their franchised shops as a "tactical marketing tool [which] should be used as such (Beacons on the Street)."[660]

The goodwill of the brand itself[661] (reputational goodwill) is also at issue in the franchise contract. Such brand goodwill is that "element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business . . . ."[662] Particularly with a trade name commanding high levels of customer recognition, brand goodwill may have been a significant factor in the decision to purchase the franchise.[663] In such a case, the franchisee pays a premium to "rent" the goodwill for the period of the franchise agreement. However, the franchisee also makes an ongoing investment in building the value (goodwill) of the trademark.

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657. Ben Silverman, *Wireless dealer has Cingular's no.*, N.Y. POST, Sept. 16, 2002, at 26.

658. *Id.*

659. *Id.* The practice is apparently not limited to Cingular. Shortly after one of the authors subscribed at a New York City dealer for AT&T Wireless, he received an e-mail offer similar to the offer described in the Cingular case. The other author had a similar experience with T-Mobile. The amounts involved are significant; the Cingular dealer claimed he was generating $350,000 per month in revenue for Cingular. Most cellular dealers are small businesses; in New York City, most are immigrants and their families. It is rare that the dealer has the resources to defend his legal rights, even if he is aware that he may have legal rights.

660. Carlock v. Pillsbury, 719 F.Supp. 791, 818 (D. Minn. 1989). The exhibit was attached to a plaintiff's attorney affidavit and the court noted that it appeared to be a March 1985 handout for an internal franchisor marketing meeting. Due to plaintiff's attempt to circumvent court restrictions on pages filed, the plaintiffs submitted attorney affidavits; the court reprimanded the attorneys but did not reject the affidavits since they were necessary to rule on the summary judgment motion. *Id.* at 799.

661. *See infra*, note 663 and accompanying discussion. *See also*, Gorenstein Enters. Inc. v. Quality Care-USAAA Inc., 874 F.2d 431 (7th Cir. 1989) (Trademark identifies product and owner of mark has duty to ensure quality control of good or service provided under trademark.).

662. Des Moines Gas Co. v. City of Des Moines, 238 U.S. 153, 165 (1915).

663. *Cf* J. THOMAS MCCARTHY, 2 MCCARTHY ON TRADEMARKS § 18:2, 18-5 (1999) ("Good will and its trademark symbol are as inseparable as Siamese Twins who cannot be separated without death to both.").

That nontransferable goodwill can be wrested from the franchisee, and courts will often rely upon the express provisions of the franchisor-drafted contract to permit what an objective observer might view as a legal but inequitable result.[664]

D. Good Faith and Goodwill: Hartford Electric v. Allen-Bradley[665]

A recent case involving both geographic and reputational goodwill indicates that some courts are willing to exercise equitable remedies to preserve the goodwill created by franchisees, viewing goodwill as fruits of the contract. The *Hartford Electric* court prevented the franchisor[666] from terminating a franchisee without good cause, notwithstanding explicit language in the franchise agreement.[667] Hartford Electric (HESCO) is a distributor of devices used in industrial equipment. The company operated on a year-to-year agreement[668] with Allen-Bradley (A-B), a large Milwaukee-based manufacturer. The agreement provided for termination by either party "at any time, with cause or without any cause" on 90 days notice.[669]

Connecticut General Statutes § 42-133f (a) provides that a franchisor must renew a franchise "except for good cause which shall include, but not be limited to the franchisee's refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement."[670]

The early 1990's were a time of national recession, and the Connecticut economy was particularly affected. In February 1992, after two years of sluggish sales, A-B placed HESCO on the "Distributor

664. Beitzell & Co., Inc. v. Brown-Forman Corp, 1988 WL 66194 (D.C. 1988).

665. Hartford Electric Supply Co. v. Allen-Bradley Co., CV 96562061S, 1997 Conn. Super. LEXIS 1411, *aff'd*, 736 A.2d 824 (1999), 1998-2000 BFG ¶11,685. On appeal, separate amicus briefs were filed by the Manufacturing Alliance of Connecticut and the Connecticut Beer Wholesalers Association.

666. *Id.* The franchisor disputed that it was a franchisor, but the court applied Connecticut law to find a franchise relationship, and cited a case applying New Jersey franchise law finding the same result. *Id.*

667. A similar holding was reached under Illinois law in Flynn Beverage Inc. v. Joseph E. Seagram & Sons, 815 F.Supp. 1174 (C.D. Ill. 1993) (also barring application of NY choice of law provision, finding conflict with antiwaiver provisions of Illinois franchise act). *But see*, Tulsa Trailer & Body Inc. v. Trailmobile (N.D. Okla. 1986) 1986-1987 BFG ¶ 8615 (applying Illinois law: if express provision allows termination without cause, no breach of implied covenant).

668. An issue not reached by the court is that Connecticut General Statute § 42-133f (d) provides that franchise renewals be for three years or more on agreements entered into or renewed after Oct. 1973.

669. Hartford Elec. Supply Co. v. Allen-Bradley Co., CV 96562061S, 1997 Conn. Super. LEXIS 1411 at *3. The facts of the case presented here have been taken from *1-*8 of the trial court opinion.

670. CONN. GEN. STAT. ANN. § 42-133(f) (West 2000).

Concern Program" (Concern Program), requiring HESCO to prepare a business plan and work with A-B to address problem areas. At the time, the DePasquale family, which controlled HESCO, was embroiled in a struggle between the father and son for control. In 1994, litigation culminated in DePasquale buying out his father's interest in HESCO. DePasquale then hired a Director of Sales (Dan Fadden) and a Director of Operations (Roy Lusk). HESCO purchases from A-B surged 20.6% in 1994 and 22.5% in 1995. In April 1995, following a meeting in Milwaukee, HESCO was taken off the Concern Program.

However, all was not well at HESCO. In October 1995, Fadden and Lusk met secretly with an A-B branch manager in Enfield, Connecticut and criticized DePasquale's management and ethics. In November, Fadden met secretly with an A-B district manager in Boston and repeated the criticism of DePasaquale. The trial court found that "after those meetings the relationship between A-B and HESCO declined."[671] Sales were down since the Milwaukee meeting in April, and in December Lusk left DePasquale's employ. A few weeks later, in January 1996, A-B placed HESCO back on the Concern Program. As justification, A-B cited inadequate staffing and training, the departure of Lusk and internal conflicts within HESCO. The following month saw the departure of Fadden and "A-B continued extensive monitoring [of] all aspects of HESCO's operations to the point that Mr. DePasquale, in a letter of April 26, 1996, protested in anger at A-B's harassment."[672] Less than a month after DePasquale's letter, A-B's Enfield and Boston managers recommended to their superior that DePasquale be terminated. Shortly thereafter, A-B gave notice of termination to DePasquale in accordance with the terms of their contract.

In assessing the potential damage if HESCO was terminated, the trial court noted that as a practical matter termination would put HESCO out of business, since it sold $10 million worth of A-B products and $10 million worth of other products which were sold in conjunction with the sale of A-B products. In applying the Connecticut Franchise Act (CFA), the court ruled:

> The public policy sought to be implemented by CFA is to protect franchisees from arbitrary and unjustified terminations. The legislative history reveals a substantial number of Connecticut businesses operate under franchises granted by national concerns. They hire many Connecticut citizens and contribute substantially to the Connecticut economy. Those Connecticut businesses invest heavily to develop a market for franchisors' products. Termination

671. *Hartford Elec. Supply Co.*, 1997 Conn. Super. LEXIS 1411, at *5-*6.
672. *Id.* at *6.

> of such franchises without good cause can create great financial losses to franchisees and to the Connecticut economy generally.
>
> *Thus, this court concludes that A-B's violation of CFA by terminating HESCO without good cause so violates an important state public policy as to amount to a breach of an established concept of fairness.*[673]

On appeal, the Supreme Court of Connecticut showed little sympathy for A-B's strict construction of the termination clause. The court noted that HESCO had been an A-B distributor for fifty years, and Connecticut customers viewed HESCO and A-B as "one and the same"[674] identity. Public perception of the HESCO/A-B relationship and nontransferable goodwill were cited by the Supreme Court in (1) finding the existence of a franchise relationship,[675] and (2) finding a degree of dependence by HESCO warranting the imposition of a good cause requirement on the contractual termination clause.[676]

Certainly, there was a statute on point in *Hartford Electric*.[677] However, neither the trial court nor the Connecticut Supreme Court limited the holding to a matter of statutory construction; both courts explicitly noted their concern with fair dealing. Both courts also took note of the relational nature of a franchise/distributorship contract. Over the course of time, the dependent party in a relational contract may grow to expect that the relationship will continue when in fact a relationship of years or even decades (50 years in *Hartford Electric*) may be terminated on a few weeks' notice due to no fault of the terminated party. The economic damage can be in the tens of millions of dollars.[678] One of the

673. *Id.* at *38-*39 (emphasis added). Connecticut cases note the state Franchise Act is for protection of the weaker party, and whether franchisee is protected may turn on how much of the franchisee's sales are of the franchisor's product. Danby's Rental & Leasing, Inc. v. U-Haul of Conn., 1993 Conn. Super. LEXIS 970 at *7-8 (Conn. Super. Ct. Apr. 23, 1993) (citing Grand Light & Supply Co., v. Honeywell, Inc., 771 F.2d 672, 677-78 (2d Cir. 1985)).

674. Hartford Elec. Supply Co. v. Allen-Bradley Co., 736 A.2d 824, 839 (1999) (quoting Cooper Distributing Co. v. Amana Refrigeration, Inc., 63 F.3d 262, 271 (3d Cir. 1995)). *See also* 1992-1993 BFG ¶ 10,094, 1995-1996 BFG ¶10,743, and 1998-2000 BFG ¶ 11,650 (litigation between Cooper and Amana).

675. Hartford Elec. Supply Co. v. Allen-Bradley Co., 736 A.2d 824, 839 (1999) (citing Sorisio v. Lenox, Inc., 701 F. Supp. 950, 961 (D.C. Conn. 1988)). *See also* 1989-1990 BFG ¶¶ 9360, 9361.

676. Hartford Elec. Supply Co. v. Allen-Bradley Company, 736 A.2d 824, 839 (1999) (quoting Grand Light & Supply Co. v. Honeywell Inc., 771 F.2d 672, 677 (2d Cir. 1985)). *See also* 1983-1985 BFG ¶ 8428.

677. Assuming, of course, the court properly found the relationship to be a franchise relationship as a matter of Connecticut law.

678. Cooper Distrib. Co., v. Amana Refrigeration, Inc., 180 F.3d 542, 544-45 (3d Cir. 1999) (Cooper, distributor for 30 years, terminated on 10 day's notice, sold $20 million

more egregious cases occurred with distributors of Thomas' English Muffins, who were terminated (one after 24 years) from their "old" routes but then offered the opportunity to buy their "new" routes back from the company.[679] Such actions create economic and social damage in the local community. It is for this reason that several states have imposed franchise laws, but the absence of a federal statute leaves many franchisees and distributors unprotected.

V. Issues During and After the Relationship

A. Good Faith and Relational Contracts: Fruits of the Contract

The Connecticut Supreme Court took a broad view of the "fruits" of a relational contract. If we use "fruit" in the sense of a mere consequence of an action, then the N.Y. Court of Appeals statement in *Kirk La Shelle* is irrelevant. If a contract results in a benefit, one of the parties is entitled to that consequence. Analyzed as property, the benefit legally belongs to one party or the other. If that benefit is blocked from reaching its rightful owner, the aggrieved party's action is for breach of contract or tortuous interference. Conversely, if no benefit flows from the contract, no benefit exists and therefore there is no benefit to be interfered with. Of what use is good faith and fair dealing in either case? The standard set out by the court in *Kirk La Shelle v. Armstrong* is broad and seemingly protective of wrongly injured parties. However, the court speaks only of the "fruits of the contract," a position presumably excluding pre-contractual acts or omissions. "Fruits of the contract" is not a model of clarity: there can be debate over what constitutes the *contract*,[680] let alone the "fruits" thereof: two of the most controversial decisions in franchise law involve whether franchisor encroachment "destroy[ed] the right of the franchisee to enjoy the fruits of the contract."[681] To understand the potential for opportunistic abuse under the current statutory scheme, it is necessary to ascertain what the "fruits" of the franchise contract consist of.[682] The relational nature of franchise

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annually of Amana products accounting for 80% of Cooper's business).

679. Smith v. CPC Baking Dist. Co., 177 F.3d 110, 113 (2nd Cir. 1999).

680. Rupert M. Barkoff, J. Michael Dady, & Alan H. Silberman, *Are Franchise Agreements Without Written Borders? Oral* Evidence *of Contract Terms and the Concept of "Integrated Contracts," in* FRANCHISING WITHOUT BORDERS at Tab LB1 (2000 ABA Forum on Franchising). *Accord* George I. Wallach, *The Declining 'Sanctity' of Written Contracts: Impact of the Uniform Commercial Code on the Parol* Evidence *Rule*, 44 MO. L. REV. 651 (1979).

681. Vylene Enterprises, Inc. v. Naugles, Inc., 90 F.3d 1472, 1477 (9th Cir. 1996) (quoting Scheck v. Burger King Corp., 756 F.Supp. 543, 549 (S.D. Fla. 1991)).

682. Also relevant in determination of remedies. Heller v. Equity Marketing, Inc.,

contracts—which can change considerably over a term lasting for as much as twenty years—make *Kirk La Shelle* difficult to reconcile with the classical view that "[a] contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties."[683] In practice the law often does recognize that the intent of the parties matters, even between sophisticated parties.[684] The fluid nature of the franchise relationship (created in large part by the extraordinary scope of franchisor discretion) *should* make the intent of the parties a critical inquiry in dispute resolution. Franchisors are justifiably concerned that government regulation of the post-sale relationship will limit franchisor ability to respond to changing conditions over the years and thereby impede franchisor receipt of the fruits of the contract. In accepting this argument, legislators should demand that good faith and fair dealing be exercised in order that franchisees may also enjoy the fruits of the contract.

Franchisees may reasonably believe that fruits of the contract include turnkey operation and ongoing operational support.[685] Franchisors will even have departments with titles such as "Store Design" and "Store Construction"[686] which would lead the franchisees to believe that the franchisor will actually be responsible for the design and construction of the store; in fact, the franchisor is concerned with Lanham Act[687] (trade dress) issues.[688] The risk is particularly acute for a

259 A.D.2d 275 (N.Y. App.Div. 1st Dept 1999) (specific performance available for breach of contract but not *quantum meruit*).

683. Hotchkiss v. National City Bank, 200 F. 287, 293 (S.D.N.Y. 1911) (Learned Hand, J.).

684. *E.g.*, Peter Nash Swisher, *A Realistic Consensus Approach to the Insurance Law Doctrine of Reasonable Expectations*, 35 TORT & INS. L.J. 729 (2000).

685. A refreshingly direct application of this is the International House of Pancakes (IHOP) turnkey program, which opens 90% of its stores and "makes them profitable before selling them to franchisees." James Peters, *Growth strategy hot on griddle as IHOP, Stewart prepare for future*, NATION'S RESTAURANT NEWS, Dec. 17, 2001, at 8, 122; *see also* Wendy Webb, *IHOP head takes different approach to franchising*, FRANCHISE TIMES, Feb. 2000 at 20. In 2003 IHOP abandoned the program after 45 years. Lori Lohmeyer, *IHOP to cut 15% of staff, regroup with franchisee operations team*, NATION'S RESTAURANT NEWS, Aug. 4, 2003, at 1. Turnkey programs can present risks for franchisors. Beth Mattson-Teig, *The pros and cons of turnkey programs*, FRANCHISE TIMES, Sept. 2002 at 34.

686. *See The HQ Development Departments*, SUBWAY TO SUBWAY (Doctor's Associates, Inc., Milford, Conn.), June 15, 2001, at 7 (citing Store Design & Construction as "departments that can help you"). *See also* DOCTOR'S ASSOCIATES, INC., THE WAY YOUR FRANCHISE SHOULD BE (Doctor's Associates, Inc.) 1998. ("Real Estate, Store Design . . . Construction . . . are just some of 25 departments at our headquarters that support our franchisees.").

687. 15 U.S.C. 1051 (2002).

688. As a franchisee, this author utilized the franchisor-provided departments and franchisor-recommended contractors to build a national franchise. Upon discovery of illegal and dangerous electrical wiring, multiple electrical failures and fires, shelving

franchisee developing a new site or purchasing a troubled outlet from an exiting franchisee; the expertise required to navigate the permit process[689] and adequately supervise a team of architects, contractors, and subcontractors is likely to be underestimated by a first-time franchisee.

The franchisees may reasonably believe that the "fruits of the contract" include advertising and marketing support and may reasonably believe that the advertising monies will be spent in a manner benefiting the franchisees who contribute the advertising dollars. However, franchisors may target spending to benefit markets with a heavy concentration of company-owned sites.

The franchisees may reasonably believe that they will own their own business and reap the benefits of the goodwill—reputational *and*

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which fell apart within a month, and a failure to provide adequate oven ventilation—which caused the restaurant temperature to rise to 130°F—the franchisor acknowledged that no electrical schematic had been produced and disclaimed responsibility to ensure that the equipment would actually *operate* in the store as "designed" in the blueprints on file with the franchisor. Although the franchisee brochure stated the franchisor would provide stores designed, inter alia, to "[f]acilitat[e] easy maintenance" and "[c]onserv[e] energy, both economically and physically" based on "questionnaires that address code and design . . . requirements," the franchise agreement contained an integration clause. DOCTOR'S ASSOCIATES, INC., A BUSINESS YOU CAN BE PROUD TO OWN 7 (1996). The franchisor's world headquarters disclaimed responsibility for the resulting monetary damages and directed the franchisee to "sell your store if you don't like it." This is a common franchisor response, (similar remark also present in the *Far Horizons* case of McDonald's Australia, during the same conversation about "when do we f**k [the franchisee]") and one American franchisor actually trains franchise reps to use this response when a problem arises. As the franchisor is well aware, the franchisee has substantially greater investments of time, money, and emotional capital invested in the business than any of the employees of the franchisor. "Sell your store if you don't like it" is an intentionally provocative response designed to elicit feelings of powerlessness in the franchisee. In the author's experience, this statement is remembered by franchisees long after the original issue is resolved. The passive-aggressive franchisor "conflict resolution" training thus may permanently poison the franchise relationship. This is not of concern to the franchisor, since as indicated by the statement, the franchisor always has the ultimate control over the business life (and frequently, life savings) of the franchisee. As Professor Hadfield observed, franchisor behavior post-contract may be quite logically based on opportunistic exploitation of the franchisee's sunk costs. Franchisor behavior can also be explained in light of the legal latitude granted by a proper integration clause. In fairness, the franchisor discussed above (Doctor's Associates) has since made radical changes to become more franchisee-friendly and the experience described above might not recur today.

689. For example, in New York City the permit process is sufficiently difficult that there are companies whose business is shepherding permits through the bureaucracy. *Expediters*, *in* BELL ATLANTIC MANHATTAN YELLOW PAGES 521 (1999). *See also* Michael Brick, *Some Suburban Restaurant Chains Are Learning About Life in the City*, N.Y. TIMES, Sept. 25, 2002 at C9 (problems in New York City include "lack of contiguous space, security deposits, union wages, delivery costs and permit expeditors"); Benjamin Smith, *Bloomberg to Overhaul Buildings Department*, N.Y. SUN, July 24, 2002 at 3 ("the department is so impenetrable by the common person that it has bred an entire industry of 'expediters. . . .'").

locational—created by the franchisees' hard work. The founder of Dunkin' Donuts noted: "Franchising gives people a sense of ownership."[690] That the "ownership" is illusory is irrelevant: The very survival of franchising is dependent upon conveying a *sense* of ownership without the *attributes* of ownership; the sense of contractual obligations without the mutual obligations contracts traditionally entail. The franchise "contract" is not a conventional contract. The obligations of the parties are set forth in the contract, and those obligations include adherence to the Operations Manual[691] and franchisor directives with respect to sourcing, upgrades, and compliance reviews. The franchisee cannot alter the contract, but the franchisor can direct the franchisee to follow policies not in effect at the time of contracting; notwithstanding that those policies may erode or eliminate the profitability of the franchise. Franchisors posit that maintaining the goodwill of the brand requires the use of suppliers selected by the franchisor;[692] one court noted that Domino's Pizza mandating the purchase of 90% of supplies from the franchisor/supplier ensures consistency such that "individual franchisees need not build up their own goodwill."[693] The franchisor then either supplies (or determines the exclusive suppliers of) the franchisee's raw materials. The franchisor retains cash "rebates," "marketing allowances" and "signing bonuses" from the designated suppliers,[694] a practice so widespread within franchising that when one franchisor was charged with the practice, it asked the judge to look at the franchisor's acts in light of industry practice.[695]

Bankruptcy may provide no relief. Although the franchise contract is generally executory and U.S. bankruptcy law provides for the assignability of executory contracts,[696] and franchisors have generally

690. *Rosenberg to Receive NRN Innovator Award*, NATION'S RESTAURANT NEWS, Sept. 10, 2001, at 4.

691. *E.g.*, Carlock v. Pillsbury Co., 719 F. Supp. 791, 803 (D. Minn. 1989) (Häagen-Dazs operations manual incorporated by reference into franchise agreement).

692. *See* 909787 Ontario Ltd. v. Bulk Barn Foods Ltd., 2000 Ont. Sup. C.J. LEXIS 1945 (2000) at *2-3 (Franchise agreement: "goodwill of the Company . . . based upon . . . sale of high quality products . . . [franchisee shall] use all and only such supplies, as are . . . approved in writing by the Company.").

693. Queen City Pizza, Inc. v. Domino's Pizza Inc., 124 F.3d 430, 433 (3rd Cir. 1997).

694. *E.g.*, Synergism Arithmetically Compounded Inc. v. Parkwood Hills Foodland Inc., 8 C.P.R. (4th) 135 (2000); 2000 C.P.R. LEXIS 181 at *11 (2000) (Fat Alberts & Ralph's Sports Bar franchisor).

695. 887574 Ontario Inc. v. Pizza Pizza Ltd., 93-CQ-33541, B85/93, 1995 Ont. Sup. C.J. LEXIS 968 at *29 (Ont. Ct. of Justice 1995) (Judge noted that both sides cited passages from the testimony of the same expert.).

696. The Bankruptcy Code (11 U.S.C. § 101) does not define "executory," which is where both parties have obligations remaining, the breach of which would be material. Mitchell v. Streets (*In Re* Streets & Beard Farm P'ship), 882 F.2d 233, 235 (7th Cir.

been unsuccessful in asserting a § 365(c)(1) (personal services contract)[697] defense—the very nature of a franchise agreement suggests that there is "no special knowledge, skill or talent" that is the essence of a personal services contract[698]—the franchisor may still avail itself of other laws to disapprove the assignment.[699] Moreover, the franchise agreement and the franchisee's lease, although separate contracts, may be deemed so interrelated as to prevent the estate from assuming the lease while rejecting the franchise.[700] Adding insult to injury, although there is no special skill, knowledge, or talent involved in running a franchise, the franchisee may remain bound post-bankruptcy by the non-compete covenant—the courts are split on the issue.[701]

If we use "fruit" in the Latin sense of fructus,[702] we are looking at a *process*—a contractual relationship involving a series of actions resulting in a series of consequences. The benefit is not from the contract *per se* but rather from the actions taken by the parties in the relationship seeking to fulfill their mutual *ongoing* expectations. Unlike a discrete transaction, in a contractual relationship that extends over an extended period of time, parties to the contract may reasonably expect that both parties may have to be flexible and not seek to opportunistically exploit unforeseen events. Indeed, the success of a relationship may hinge on

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1989). Executory contracts are assignable (subject to adequate assurance of future performance) even when the contract does not permit assignment. Worthington v. General Motors Corp. (*In Re* Claremont Acquisition Corp.), 113 F.3d 1029, 1032 (9th Cir. 1997).

697. *See In re* Sunrise Rests., Inc., 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991) (stating that "Section 365(c)(1) was designed only to prevent a Debtor-In-Possession from assigning unexpired executory contracts including personal service contracts, which are ordinarily not assignable by law").

698. *In re* Tom Stimus Chrysler-Plymouth, Inc., 134 B.R. 676, 679 (Bankr. M.D. Fla. 1991); *accord In re* Sunrise Rests., Inc., 135 B.R. 149 at 149.

699. *See In re* Pioneer Ford Sales, Inc., 729 F.2d 27 (1st Cir. 1984) (demonstrating Rhode Island law); *see also* Beverages Int'l, Ltd. v. Schenley Affiliated Brands Corp., 61 B.R. 966 (Bankr. D. Mass. 1986) (demonstrating Massachusetts law). *But see In re* Coors of North Mississippi, Inc., 27 B.R. 918 (N.D. Miss. 1983) (holding that assignment was permitted with cure period of 3 years to pay franchisor creditor). State laws regarding franchise transfers may be found in FRANCHISE DESK BOOK: SELECTED STATE LAWS, COMMENTARY & ANNOTATIONS (W. Michael Garner, ed. 2001). UCC 9-408 permits the creation of a security interest in a franchise notwithstanding franchise agreements to the contrary. However, the trustee may not use the contract right against a franchisor with an otherwise enforceable right. Additionally, the contractual right of first refusal may be void under the Bankruptcy Code. *See In re* Headquarters Dodge, Inc. 13 F.3d 674 (3d Cir. 1993).

700. Cottman Transmissions, Inc. v. Holland Enters., Inc. (*In re* Holland Enters., Inc.) 25 B.R. 301 (Bankr. E.D. N.C. 1982).

701. Craig R. Tractenberg, *What the Franchise Lawyer Needs to Know About Bankruptcy*, 20 FRANCHISE L.J. 3, 6 (2000).

702. OXFORD ENGLISH DICTIONARY (1989). *Fructus* is a more expansive view in that it involves use and enjoyment, an ongoing process and not simply a discrete result.

the ability of the parties to go beyond the strict language of the contract. An early example is *Edgington v. Fitzmaurice.*[703] Directors of a fish wholesaler on the verge of insolvency invested additional funds to keep the company afloat, even though not contractually obligated to do so. This action, said the Chancellor, "shewed *bona fides* on their part."[704] This is a view not only of the product of a contract but the process of a relationship contract, and good faith is a logical component of such a contract. Franchising contracts are best viewed in this manner: the ongoing nature of a franchise agreement requires such a viewpoint if the franchise relationship is to make economic sense. This is beyond the "mutuality" that the New York Court of Appeals disfavors:[705] a better view would be that of a bilateral contract[706] requiring "contractual solidarity": "Longer in focus than mutuality, [contractual solidarity] is a belief in the future interdependence of the parties, which fosters a desire to maintain the relationship."[707]

The concept of contractual solidarity is particularly useful in the analysis of franchise relationships. The view that "a contract is a contract" and that there is no difference between discrete and relational contracts is a legal fiction that is not borne out by common experience.[708] A New Zealand court explained:

> [T]he Court's inquiry is not limited to the intention expressed in any written contract but can be deduced from all the circumstances and an examination of the history of the contract in operation because, as it is important to recognise, the Court is dealing not with a contract governing a single transaction but with a contract governing a

703. 1885 29 Ch. D. 459 (Eng. C.A.). Probably the earliest reported case specifically addressing good faith in commercial relationships.

704. *Id.* at 468 (emphasis added). However, the court found the subsequent shareholder prospectus deceptive and held the directors liable, prior *bona fides* notwithstanding.

705. Weiner v. McGraw-Hill Inc., 443 N.E.2d 441, 444 (N.Y. 1982). New York has taken the traditional view of contracts, viewing anything beyond the four corners as a slippery slope the court should avoid. A minority view is that courts should inquire "into the circumstances surrounding a contract even where no ambiguity as to finality or intended meaning is apparent on the face of the document." *See* Tigg Corp. v. Dow Corning Corp., 822 F.2d 358, 363 (3d Cir. 1987).

706. Although the distinction between bilateral and unilateral contracts is often abandoned as archaic, it is useful in the analysis of franchise agreements. *See generally* I E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §3.4 (2d ed. 1998) (discussing the meaning ot "bilateral" and "unilateral" and the abandonment of these terms).

707. Mark T. Spriggs & John R. Nevin, *The Relational Contracting Model and Franchising Research: Empirical Issues*, *in* FRANCHISING: CONTEMPORARY ISSUES AND RESEARCH, 141, 145 (Patrick J. Kaufman & Rajiv P. Dant eds., 1995).

708. *See* Hadfield, *supra* note 93 (demonstrating unique nature of franchise agreements and resultant franchisor opportunism in the post-contractual phase). *But see supra* note 94 (criticizing Hadfield's analysis).

> continuing contractual relationship. It is a living thing and it is not possible to freeze-frame it at any particular moment such as the moment of signature of the contract and say that the picture so produced represents for all time and for all purposes the intention of the parties.[709]

Franchise contracts are living things because, *inter alia*, they incorporate Operations Manuals and franchisor directives which permit unilateral alteration *ex post* of the rights and obligations under the contract. Franchise attorney J. Michael Dady noted: "There is a difference between a writing to buy a horse and a writing to enter into a 20-year agreement."[710] Dady was speaking of the role of an integration clause, but the principle applies in the area of good faith as well. If good faith is viewed not as an absolute standard but as a standard that is contextual and is applied in light of the totality of the circumstances, the standard of good faith in a franchise relationship can be higher than the standard of good faith imposed in a discrete contract. Indeed, good faith is most useful when evaluating relationship contracts whose attendant discretion is the cause of much mischief. When the Carvel ice cream franchisor allegedly refused to allow alterations to blueprints required by the Maryland Health Department, and took other steps to frustrate the ability of a sub-franchisor to perform under the contract, the trial court refused a jury instruction that Carvel had a duty of good faith.[711] On appeal, the court held that "even if it acted within the bounds of its discretion, Carvel would be in breach [of the duty of good faith and fair dealing] if it acted unreasonably."[712]

B. Good Faith

Contract formation is a universal human trait and contractual fairness is notable for its fundamental role in contract.[713] The idea of good faith (*bona fides*) in modern commercial law is of Roman origin[714]

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709. TNT Worldwide Express (NZ) Ltd. v. Cunningham, [1992] 3 E.R.N.Z. 1030, 1033 (Employment Court), *rev'd*, [1993] 3 N.Z.L.R. 681 (C.A. Wellington).

710. J. Michael Dady, Address at ABA Forum on Franchising, (Oct. 19, 2000). *Accord* CHARLES FRIED, CONTRACT AS PROMISE 73 (1997) ("penumbra" of involvement greater for seller of machinery to factory over several years versus seller of single item).

711. Carvel Corp. v. Diversified Mgmt. Group, 930 F.2d 228, 230-231 (2d Cir. 1991).

712. *Id.* at 232.

713. *Cf.* EDWARD O. WILSON, CONSILIENCE: THE UNITY OF KNOWLEDGE 186-187 (1998) (detection of cheating by party to contract, citing Leda Cosmides & John Tooby, *Cognitive adaptations for social exchange*, in THE ADAPTED MIND 163-228 (Jerome H. Barkow et al., eds. 1992)).

714. *See generally* Martin Josef Schermaier, *Bona Fides in Roman contract law*, *in* GOOD FAITH IN EUROPEAN CONTRACT LAW 63-92 (2000). *See also*, Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL

and recognized by many legal systems as an essential element of the contractual relationship.[715] What precisely is being recognized is another matter: not only do national systems differ, but the growth of international trade led the drafters of the UNIDROIT *Principles of International Commercial Contracts* to postulate a definition of good faith and fair dealing "construed in the light of the special conditions of international trade."[716] The *Principles* also make good faith non-waivable:[717] "The parties' duty to act in accordance with good faith and fair dealing is of such a fundamental nature that the parties may not contractually exclude or limit it."[718]

The American approach to contractual good faith is set forth in the Restatement (2d) of Contracts § 205: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[719] The Comment to § 205 further notes the Uniform Commercial Code (UCC) definition of "honesty in fact"[720] and injects a moral note by stating that good faith excludes actions "involving 'bad faith' because they violate community standards of decency, fairness, or reasonableness."[721] This circuitous definition is seen in the case law, and is the result of a practical difficulty: "Good faith" is a more amorphous concept than its opposite, "bad faith." Like obscenity, "bad faith" may be difficult to define in an intelligible manner, but we "know it when we see it."[722] In the leading Australian case adopting the implied covenant of good faith, the court noted, with approval, that American judges had used "good faith" to exclude bad faith and "do justice according to law."[723]

L. REV. 70, 80 (1993) (describing historical development of good faith).

715. *E.g.*, CIVIL CODE art. 3(1)(2) (Switz.) (providing when *bona fides* is presumed and that one must exercise "degree of care" to plead *bona fides*).

716. *See* International Institute for the Unification of Private Law, Principles of International Commercial Contracts, art 1.7(a), cmt . 2 (1994) [hereinafter UNIDROIT PRINCIPLES].

717. UNIDROIT PRINCIPLES art. 1.7(2).

718. *Id.* at cmt. 3.

719. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

720. U.C.C. § 1-201(19) (2001).

721. RESTATEMENT, *supra* note 719, at Cmt. (a).

722. Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring). Potter Stewart's famous observation illustrates the common sense which courts use every day to define the parameters of acceptable behavior. Indeed, some attorneys maintain that this approach is increasingly followed by courts in the resolution of franchise disputes. Professor Robert Summers followed this approach of defining good faith by excluding bad faith, and noted six examples of bad faith, of which one (evading the spirit of the deal), is often in franchising a result of two other examples of bad faith: abuse of power to specify terms and abuse of power to determine compliance. Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 232-43 (1968).

723. Renard Constructions (ME) Pty. Ltd. v. Minister for Public Works (1992) 26

Apart from defining good faith as not being bad faith and remaining silent on the issue of whether the parties can contract around § 205,[724] the Comment's moral tenor causes further difficulties. American contract law is not alone in this predicament; German law declares: "a transaction in violation of good morals is void."[725] Italian law declares: "the *causa* [of contract] is unlawful when it is contrary to . . . morals."[726] Such laws imply more than holding void a contract entered into for an illegal purpose: immorality is different from illegality. Immorality is not necessarily a religious concept, and the use of law as an expression of moral standards is not necessarily an expression of religious belief; perhaps we have mistaken the cause for the effect. Such error leads to the absurdities of extreme laissez-faire and the hollow jurisprudence of Oliver Wendell Holmes.[727] A growing number of sociologists and cognitive neuroscientists postulate that moral behavior (and the moral tenor of the law) is a manifestation of an adaptive mechanism which is partly innate and partly learned.[728] To the extent that this adaptive mechanism lowers transactional costs among ever-widening circles of individuals, there is a sound economic basis for ensuring the maintenance of sanctions against opportunistic actors. Whatever conceptual basis is used, good faith is woven through Western contract law.

The Swiss Civil Code places the requirement of good faith at the beginning of the Code itself—a principle of general applicability in Swiss law.[729] Although many civil code nations have moved towards a more laissez-faire approach in recent years, there is still a markedly more receptive attitude towards contractual good faith concepts in the civil systems of France,[730] Germany,[731] Italy,[732] and Israel[733] than in the

N.S.W.L.R. 234, 266-68. The history of good faith in Australia is discussed by the Court of Appeals of the Supreme Court of New South Wales, in Burger King Corp. v. Hungry Jack's Pty. Ltd. (2001) N.S.W.L.R. 187.

724. U.C.C. § 1-102(3) provides that good faith is an obligation that may not be disclaimed. In reality, good faith in American franchise agreements is more notable by its absence.

725. BURGERLICHES GESETZ BUCH [BGB] [Civil Code] § 138 (F.R.G.).

726. CODICE CIVIL [C.C.] art. 1343 (Italy).

727. Holmes' cynical abnegation of the moral underpinnings of the law was in response to the horrors he witnessed during the Civil War, which began for many as a moral crusade. *See* LOUIS MENAND, THE METAPHYSICAL CLUB 23-69 (2001).

728. PINKER, *supra* note 25, at 186-194.

729. *See* C.C. art. 2 (Switz.), *supra* note 715.

730. CODE CIVIL [C. CIV.] art. 1134 (3) (Fr.). Refers to execution of contract in good faith (*bonne foi*).

731. BGB § 157, and most famously, § 242 (F.R.G.). Contracts *interpreted* as requiring good faith and credit (*Treu und Glauben*). German translation of UNIDROIT PRINCIPLES art. 1.7 (good faith and fair dealing) is *Guter Glaube und redliches Verhalten*. *See generally*, NORBERT HORN, HEIN KÖTZ, & HANS LESER, GERMAN PRIVATE

systems descended from English common law. In fact, it was at the time of Israel's adoption of a civil code in 1973 that the duty of good faith was introduced into contract law, not only in contractual *performance,* but in the *negotiation* and *drafting* of the contract as well.[734] The cool detachment of Justice Holmes is not shared by judicial systems abroad, nor has it been shared through history.

Fair play has long been a concern of jurists and lawyers. Judge Rosenblatt of the New York Court of Appeals noted that "[t]he development of the law involves elements of philosophy, religion, governance, morality, and human emotions . . . ."[735] As one historian noted, even Canon lawyers of the Middle Ages struggled with the "amorphous concepts" of contractual good faith and equity. They found it difficult to reconcile Christian dictates with contractual realities,[736] an issue that resurfaced recently for one franchisor claiming to operate according to "Christian principles."[737] This difficulty was not new to the Middle Ages; Western commercial contract law may have originated in an attempt to circumvent Biblical law.[738] The origins of franchising may be in the Middle Ages,[739] but the problems of franchising are not confined to the Middle Ages. A Canadian judge compared one franchise system to a "fiefdom"[740] and the leading American franchisee organization noted:

AND COMMERCIAL LAW, 134-145 (1982) (writing on contractual good fait in Germany). In 1999 there were 32,899 franchised outlets in Germany, and U.S. franchisors had a 9.6% market share. *When In Germany* (table), FRANCHISE TIMES, May 2001 at 10.

732. C.C. art. 1366 (Italy) (providing that a contract shall be interpreted according to good faith. Note also art. 1362 which provides that the "common intent of the parties, not limited to the literal words of the contract, shall be sought in interpreting the contract.").

733. Nili Cohen, *The Effect of the Duty of Good Faith on a Previously Common Law System: The Experience of Israeli Law, in* GOOD FAITH IN CONTRACT: CONCEPT AND CONTEXT 189-212 (Roger Brownsword, Norma Hird, Geraint Howells, eds. 1999); *see also* Nili Cohen, *Pre-Contractual Duties: Two Freedoms and the Contract to Negotiate, in* Jack Beatson & Daniel Friedmann, GOOD FAITH & FAULT IN CONTRACT LAW 25 at 42, n.70 (Jack Beatson & Daniel Friedmann eds., 1997).

734. COHEN, *supra* note 733 at 189.

735. Albert M. Rosenblatt, *The 55th Annual Cardozo Memorial Lecture: The Law's Evolution: Long Night's Journey Into Day*, 24 CARDOZO L. R. 2119, 2120 (2003).

736. James Gordley, *Good faith in contract law in the medieval* ius commune, *in* GOOD FAITH IN EUROPEAN CONTRACT LAW 93, 95 (2000).

737. *ChemDry, supra* note 122.

738. Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 556 (1933). *Prosbul* was a contract to avoid Deuteronomy 15:1-9, which released debtors from obligations on a seven-year cycle akin to bankruptcy discharge. Interestingly, the dictate did not apply to foreigners—one of the earliest examples of a distinction between "domestic" and "international" law.

739. PURVIN, *supra* note 180, at 39-42 (origins traced to medieval Church).

740. Shelanu Inc. v. Print Three Franchising Corp., 2000 Ont. Sup. C.J. LEXIS 3002, at *51-52 (Ont. Sup. C.J., 2000).

> [U]nscrupulous franchisors . . . deny their franchisees the realization of goodwill and value they may have invested many years and their life savings to develop.
>
> In this respect, franchising today most resembles indentured servitude. In the Middle Ages, people would "freely" choose to bind themselves to the land, work it for a number of years and pay a large portion of the profits to the landowner . . . . When the indenture period was up, you were faced with a choice, re-pledge yourself to the feudal lord, even if he demanded twice his prior share, or simply walk away from the home you built and the crops you developed.[741]

The feudal analogy is unfair to medieval jurisprudence. In fact, when the feudal system dissolved one of the legal questions was to what extent the nascent laissez-faire system should replace the obligations owed to the weaker party: unlike franchising, feudal privilege conferred responsibilities as well as benefits in an amalgam of written, unwritten, secular, and ecclesiastic mores.[742]

Baron Thurlow observed "Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?"[743] Subway founder Fred DeLuca told the *Janotta* court that he did not have any responsibility to tell landlords that they were leasing to a shell company controlled by DeLuca since "It's not a requirement under the law."[744] Justice Holmes observed: "The law is the witness and

741. Letter from Susan P. Kezios, AFA President, to Donald S. Clark, FTC Secretary (January 31, 2000), *available at* http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment037.htm. In one case, franchisees made a claim for unpaid labor, and an Australian court agreed: "The necessity of working, without any financial reward, much longer each week than one had intended or desired . . . is in our opinion, such a prejudice or disadvantage as the law will treat as compensable in damages, and therefore, properly included as part of the consequential loss sustained by [franchisee purchasers]." Cut Price Deli Pty. Ltd. v. Jacques, (1994) 49 F.C.R. 397 at 404, *cited in* Carlton v. Pix Print Pty. Ltd., [2000] F.C.A. 337, QG 30 of 1997, Fed. Ct. of Australia, Queensland District Registry (Mar. 22, 2000). *Carlton* held that "something is allowable to [the franchisee] in respect of loss of opportunity to earn ordinary income. . . . It is only the effort additional to that which the purchaser could have expected to have to put into the business purchased that can be the subject of a damages award where the purchase was wrongly induced."

742. *See* ROBERTS, *supra* note 89, at 690-691 (1846 repeal of English "Corn Laws"); *see also id.* at 708 (1789 abolition of feudal dues in France also abolished peasants' communal rights).

743. OXFORD DICTIONARY OF QUOTATIONS 550 (3d ed. 1979) (quoting Edward, First Baron Thurlow).

744. Behar, *supra* note 46, at 134. DeLuca has since changed his mind, and now encloses in his leases a lengthy rider in bold-faced type discussing this point. Both the landlord and the Subway agent must specially initial that specific paragraph of the rider. Much as DeLuca epitomized the abusive franchisor in the past, he is now a model for other franchisors wishing to operate a more fair and balanced franchise relationship.

external deposit of our moral life."[745] Franchisor counsel, however, may disagree. According to the former controller for the Subway franchisor, general counsel Leonard "Lenny the Ax" Axelrod said: "If you're looking for morality, leave it outside the door."[746]

American law may be uncomfortable with the blending of morality and contract, but as an equitable doctrine, good faith and fair dealing is a reflection of societal mores. In *Hungry Jack's*, the Australian court found that Burger King's actions "constituted a failure to conform with basic commercial morality."[747] A Nova Scotia court observed that an overbearing franchisor evidenced a "marked departure from normal business ethics or morality,"[748] and Ontario now requires franchisors and franchisees "to act in good faith and in accordance with reasonable commercial standards."[749] In the U.S., recent changes to Article 1 of the Uniform Commercial Code include amending the definition of good faith from "honesty in fact" to add "observance of reasonable commercial standards of fair dealing."[750]

Moral values appear to have an innate biological basis: concepts of moral awareness are observed in infants.[751] The developing science of neuroeconomics suggests that innate emotions confer an adaptive advantage in the marketplace,[752] but this view is not widely held in the legal community. Judge Posner of the Seventh Circuit espouses the majority view that the basis is not biological, but theological:

> The moral and mental baggage of the law is connected to the fact that the basis of most legal principles is tradition, and the tradition, heavily Judeo-Christian, is saturated with moral concepts that

745. Oliver Wendell Holmes, *The Path of Law*, 10 HARV. L. REV. 457, 459 (1879). This is a bit incongruous coming from a man whose recent biographer (Prof. Alschuler of the University of Chicago) titled his work: "Law Without Values: The Life, Work, & Legacy of Justice Holmes."

746. Behar, *supra* note 46, at 134. Axelrod denies making the statement. *Id.*

747. Hungry Jack's Pty. Ltd. v. Burger King Corp, 1999 N.S.W. LEXIS 61 at *236 (Sup. Ct. of New South Wales, Equity Division, Commercial List 1999). *See also* Janet Sparks, *Australian court hits BK with $45M judgment*, FRANCHISE TIMES, Feb. 2000 at 41.

748. A&K Lick-a-Chick Franchises Ltd. v. Cordiv Enters. Ltd., 56 C.P.R. (2d)1, 4 (C.P.R. 1981).

749. Arthur Wishart Act § 3(3) (2000) (dealing with "Franchise Disclosure").

750. A.L.I., Actions Taken on 2001 Annual Meeting Drafts, *available at* www.ali.org/ali/ALI2001_ActionsTKN.htm; *see also* U.C.C. § 1-201(b)(20) (2001).

751. PINKER, *supra* note 25.

752. *Human Nature: Who do we think we are?*, NEW SCIENTIST, May 17, 2003 at 34. *See also* sidebar, *Play Fair, Why Don't You?*, *id.* at 36 (Antonio Damasio's study of man with prefrontal cortex damage who made shortsighted economic decisions leading to long-term loss, failed to show galvanic skin response of "normal people," indicating no emotional arousal on the part of the unsuccessful player).

emphasize state of mind.[753]

The Seventh Circuit has been quick to disabuse litigants of any such moral concepts: "contract law does not require the parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother's keeper."[754] As the judicial wellspring of the Law & Economics ("Chicago School") movement, the Seventh Circuit's hostility to good faith springs from the belief that imposition "would reduce commercial certainty and breed costly litigation."[755] The implied covenant of good faith and fair dealing reflects a sense of fair play, and most non-lawyers would agree with the New York Court of Appeals' decision in *Kirk La Shelle Company v. Paul Armstrong Company*, finding that all contracts contain:

> an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.[756]

From the language of *LaShelle*, it would appear that good faith and fair dealing is a principle of general applicability in contract law similar to civil code nations and similar to the UNIDROIT *Principles*. There is probably no case of a court holding that good faith is not required in contractual performance,[757] but American law looks to the *expressed* intent as controlling; a party may contract with the *actual* intent to operate in bad faith while remaining within the four corners of the contract.[758] Judicial adherence to the "four corners" approach effectively

753. RICHARD A. POSNER, THE PROBLEMATICS OF MORAL AND LEGAL THEORY 208 (1999).

754. Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992). The reference is to the story of Cain & Abel, *Genesis* 4:9. On Greek and Roman concepts of commercial good faith. *See* Laidlaw v. Organ, 15 U.S. 178, n.C (1817) but note that the Franchise Rule and securities laws have imposed an obligation to disclose.

755. Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990) (Easterbrook, J.). *See* Dennis M. Patterson, *A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 IOWA L. REV. 503 (1991).

756. Kirk La Shelle Co. v. Paul Armstrong Co., 188 N.E. 163, 167 (N.Y. Ct. App. 1933). New York does not recognize breach of implied covenant of good faith as an independent cause of action for franchisees. McGowan v. Pillsbury Co., 723 F. Supp 530 (W.D. Wash. 1989).

757. Robert S. Summers, *The General Duty of Good Faith: Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 812 (1982) (citing 47 ALI PROCEEDINGS 490 (1970)).

758. *See* Cenac v. Murry, 609 So. 2d 1257 (Miss. 1992) (*Cenac* is a case worth reading for descriptions of Murry's behavior, which included placing a dead cat on the property line and banging on his chest like a gorilla while shirtless and bellowing "ho ho ho." Such conduct necessarily dissuaded customers from patronizing Cenac's store.); *see*

permits bad faith behavior, as Congressman LaFalce observed:

> franchisees confront a tremendous imbalance in franchise contracts that bind them to accept virtually all actions and decisions of their franchisor no matter how arbitrary or abusive . . . . And franchisors have vigorously enforced these contracts with the help of courts that have most often refused to consider anything beyond the strict terms of the contract.[759]

Then-D.C. Circuit Judge Antonin Scalia (now a U.S. Supreme Court Justice) maintained in *Tymshare, Inc. v. Covell* that artful drafting may eviscerate the implied covenant: "It is possible to draw a contract as to leave decisions absolutely to the uncontrolled discretion of one of the parties and in such a case the issue of good faith is irrelevant."[760] Another court stated that "a party cannot maintain a claim for breach of the implied covenant of good faith and fair dealing where the party cannot claim a breach of any express contractual provision."[761] This accords with the prevailing view that the implied covenant of good faith does not provide for an independent cause of action.[762] In an unpublished opinion, however, the Third Circuit held in a distributor termination case that breach of the implied covenant could be the basis for a claim even absent breach of an express provision.[763] At the far end

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also 17A AM.JUR. 2D *Contracts* § 352 (1999). *But see* Alan's of Atlanta, Inc. v. Minolta Corp., 903 F.2d 1414 (11th Cir. 1990) (holding that good faith doctrine applied to prevent *de facto* breach of terms where performance maintained *de jure*). Also, In many countries, the reverse is true; for example, Australian courts hold that good faith is implied based not on the intention of the parties "but as a legal incident of the relationship," Garry Rogers Motors (Aust.) Pty. Ltd. v. Subaru (Aust.) Pty. Ltd., FCA 903, V 342 of 1999, 1999 Aust. FEDCT LEXIS 495 at *18 (citing recent cases).

759. *Franchising Relationship*, *supra* note 49, at 14 (Prepared Statement of Hon. John J. LaFalce (D-NY).

760. Tymshare, Inc. v. Covell, 727 F.2d 1145, 1153-54 (D.C. Cir. 1984) (Scalia, J.) (quoting MacDougald Constr. Co. v. State Highway Dep't, 188 S.E. 2d 405, 407 (Ga. Ct. App. 1972)). Judge Posner suggests that courts could even dispense with the entire doctrine of good faith. Market St. Assocs. Ltd. P'ship v. Frey, 941 F.2d 588, 596 (7th Cir. 1991).

761. Barnes v. Burger King Corp., 932 F. Supp. 1420, 1440 (S.D. Fla. 1996). Some courts have recognized the implied covenant as an independent cause of action. Burger King Corp. v. Austin, 805 F. Supp. 1007, 1013 (S.D. Fla. 1992) (Florida law, citing Scheck v. Burger King Corp. 798 F. Supp. 692 (S.D. Fla. 1992)). Particularly in states which do not recognize the implied covenant as an independent cause of action. McGowan v. Pillsbury Co., 723 F. Supp. 530 (W.D. Wash. 1989), 1989-1990 BFG ¶ 9409 (New York law); Alan's of Atlanta Inc. v. Minolta Corp., 903 F.2d 1414 (11th Cir. 1990), 1989-1990 BFG ¶ 9636. Artful drafting and unilateral alteration of contracts can cause a wronged franchisee to suffer summary judgment as a plaintiff while being mulcted in damages as a defendant.

762. The Permanent Editorial Board for the Uniform Commercial Code holds this position in *Commentary No. 10* (Feb. 10, 1994).

763. Unidrug, S.A.R.L. v. E.T. Browne Drug Co., Inc., Bus. Franch. Guide ¶ 11,415

of the spectrum, one court held that an implied covenant can never be found in a fully integrated agreement.[764]

A more balanced approach is Justice Cardozo's view that:

> Our guide is the reasonable expectation and purpose of the ordinary businessman when making an ordinary business contract. It is his intention, expressed or fairly to be inferred, that counts.[765]

A similar view was taken by the Supreme Court of Nevada, which held that "contractual relations which involve a special element of reliance," such as franchise agreements, contain an implied covenant of good faith.[766] In that Nevada case, a distributorship agreement was terminated after 16 years. The manufacturer had an option—but not an obligation—to repurchase the $30,000 of inventory (now worthless to the distributor) and refused to do so. In reversing the trial court, the Supreme Court of Nevada stated that the parties could not take "arbitrary action" disadvantaging the other party, and remanded with a finding that the manufacturer be directed to repurchase the inventory.[767]

Ontario has codified a good faith requirement in franchise contracts.[768] This was in keeping with Canadian jurisprudence, which had previously recognized that the "standard is breached when a party acts in a bad faith manner in the performance of its rights and obligations under the contract."[769] Contrary to the U.S., a party can be within the four corners of the contract and still unlawfully act in bad faith, which Canada defines as "conduct that is contrary to community standards of honesty, reasonableness or fairness."[770]

Franchisors argue that they can exempt themselves from the implied covenant of good faith by a contractual provision stating that implied covenants do not apply. In *Amoco Oil Company v. Ervin*, the jury awarded damages after hearing testimony that Amoco's rent charged to franchisees double-charged certain items.[771] The appellate court affirmed, and on appeal to the Supreme Court of Colorado the primary

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(3d Cir. 1998).

764. Tri-County Retreading, Inc. v. Bandag, Inc., 851 S.W.2d 780, 784 (Mo. Ct. App. 1993) (applying Iowa law to a case of first impression in the franchise context and citing Fashion Fabrics of Iowa, Inc. v. Retail Investors Corp., 266 N.W.2d 22, 28 (Iowa 1978)). The franchise agreement in *Tri-County* contained a standard "Entire Agreement" clause).

765. Bird v. St. Paul Fire & Marine Ins., 120 N.E. 86, 87 (N.Y. 1918).

766. Overhead Door Co. of Reno, Inc. v. Overhead Door Corp., 734 P.2d 1233, 1235 (Nev. 1987).

767. *Id.*

768. Arthur Wishart Act § 3 (2000).

769. Gateway Realty Ltd. v. Arton Holdings Ltd. and LaHave (No. 3), [1991] 106 N.S.R.2d 180, 191-192.

770. *Id.*

771. Amoco Oil Co. v. Ervin, 908 P.2d 493, 497 (Colo. 1995).

issue was whether the implied covenant of good faith and fair dealing could override express provisions of the contract. Amoco claimed that since the contract gave Amoco the right to set the rent formula and explicitly stated that there were no implied covenants in the integrated contract, the jury and the appellate court were wrong.[772] A divided Court held that the dealers had left Amoco with the discretion to modify the rental terms, and since the contract terms required the dealers to rely on Amoco's good faith, the issue of whether Amoco had acted in good faith was properly one for the jury.[773] The dissent cited Scalia's *Tymshare* opinion in supporting Amoco's right to double-charge, without concern for good faith and fair dealing: "the reason may be purely a whim or caprice."[774] The dissent claimed that "although good faith is generally applicable to all contract provisions," Amoco had drafted a contract which permitted unfettered discretion in the setting of franchisee rentals.[775] The *Amoco* dissent reverses the traditional view of good faith: "[C]ourts rely on the implied good faith covenant '[w]here a party to a contract makes the manner of its performance a matter of its own discretion.'"[776] As one of the *McDonald's* cases explained:

> The doctrine of good faith performance imposes a limitation on the exercise of discretion vested in one of the parties to a contract . . . a party vested with contractual discretion must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.[777]

Amoco v. Ervin illustrates the reason why franchisors find jury trials to be "a scary thing."[778] Jurors—and unsophisticated franchisees—see franchisor discretion as limited by standards of commercial morality.[779]

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772. *Id.*

773. *Id.* at 499. The court also distinguished between disparity of bargaining power and disparity of power due to the ability of the franchisor to exercise discretion: "the dependent party is then left to the good faith of the party in control." *Id.* The concept of "dependent party" was developed by Steven J. Burton, *Breach of Contract & the Common Law Duty to Perform in Good Faith*, 94 HARV. L.REV. 369 (1980), and Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984).

774. *Amoco*, 908 P.2d at 506.

775. *Id.*

776. Hubbard Chevrolet Co. v. General Motors Corp., 873 F.2d 873 (5th Cir. 1989) (quoting Burkhardt v. City Nat'l. Bank, 226 N.W.2d 678, 680 (Mich. Ct. App. 1975)).

777. Dayan v. McDonald's Corp., 466 N.E.2d 958, 972 (Ill. App. Ct. 1984).

778. Edward Wood Dunham, *A Rare But Scary Thing: More on Franchise Jury Trials*, 21 FRANCHISE L.J. 179 (2002).

779. *Cf.* Mary S. Diemer, *Whom Do You Trust?*, LITIG. NEWS, May 2001 at 8 (75% of those surveyed believe executives of big companies cover up bad behavior, 30% say high damage awards are necessary to teach lesson).

But courts have held that franchisors may site competing outlets near existing franchisees[780] and use franchisees as chum to garner customers for the franchisor's alternate distribution channels.[781] Some judges will find no violations of the covenant of good faith if the contract permits franchisor discretion. *Limiting* the scope of the franchisor's obligations and *expanding* the scope of the franchisee's obligations—frequently by unilateral post-contractual alterations by the franchisor[782]—reduces the likelihood that the franchisee can claim breach of contract. However, it raises to a near-certainty the ability of the franchisor to claim breach on a violation—even a violation based on the subjective view of the franchisor.

C. *Franchise Litigation*

One way a franchisee attempts to reduce dissonance is to ignore or downplay the franchisor's litigation history, an Item 3 disclosure often buried deep within the UFOC as an Exhibit at the end of the offering circular. Another alternative may be for the franchisor's agent to tell the prospect that there is no need to worry since those are all disgruntled lazy franchisees—and of course, the prospective franchisee isn't one of *those*, right? Franchisors can appeal to anti-lawyer sentiment to overcome the plain language of the document their own counsel has drafted; salespersons telling prospects who question the UFOC: "Oh, our lawyers make us say that . . . don't worry, we don't sue good franchisees, we're in a partnership together and if you lose we lose"—blaming the franchisee victim reduces dissonance caused by the litigation history, because if bad things happen to bad people, then *we* are safe.[783] Worse still, the UFOC is misleading since it fails to disclose cases where a franchisee was coerced into taking an action or coerced into selling his franchise by the mere threat of franchisor action. A franchisor can send certified letters by the thousands with a click of a mouse and debit the franchisees' bank accounts for the privilege.[784]

An Australian Member of Parliament stated that one franchisor used court proceedings to drive franchisees "to the wall" and that one

780. Patel v. Dunkin' Donuts of America, Inc., 496 N.E.2d 1159, 1161 (Ill. 1986).

781. Carlock v. Pillsbury Co., 719 F. Supp. 791, 818 (D. Minn. 1989).

782. Accomplished by modifications to the Operations Manual, forcing the franchisee to sign a new agreement and selective enforcement of system standards.

783. A comprehensive discussion of this and related heuristics is discussed in ATLA's annual "Overcoming Juror Bias" seminars, which offer insight into the decisionmaking processes of adults in the United States. *See, e.g.*, www.atla.org/cle_con/03041ojb_tr.aspsx (offering "overcoming juror bias college").

784. Since no figures are published, the extent of this practice is difficult to quantify. This author is reliably informed that one franchisor sent out over 4,000 such letters in a single calendar year.

franchisor had driven five franchisees to suicide.[785] A Canadian court advised:

> Franchisees should recognize that they require a degree of sophistication including a willingness to read the fine print of a standard form contract, and the stamina to do so notwithstanding the franchisor's representative suggesting strongly that the prospective franchisee need not bother with all the legal jargon. There is the frequent suggestion that the franchisor is not going to rely on it given the mutual desire of the franchisor and the franchisee to make lots of money.[786]

A legal affairs officer for Hardee's claimed that:

> [W]e can end up without a royalty . . . if we kick [the franchisee] out. On top of that, it is by no means clear who would win in litigation. The big company picking on the small entrepreneur does not usually play well in front of juries.[787]

The Hardee's claim ignores franchising realities. The franchisor can simply replace the franchisee with a new one, or run the Hardee's as a company store. Of course, given that Hardee's had to increase its allowance for franchisee doubtful accounts receivable from 38% to 54% and refranchise company stores in the wake of large increases in workers' comp and healthcare costs, it is unlikely that Hardee's would want to convert *any* outlet to a company store.[788] Hardee's can also sue a terminated franchisee for breach of contract and lost profits.[789] The lack of franchise statutes and powerful trademark laws make it pretty clear who would likely win in litigation: according to the IFA franchisors win 98% of the time,[790] a courtroom record which would be the envy of the

785. Philip F. Zeidman, *Shattering the myths*, FRANCHISE TIMES, Apr. 2002 at 27. The interplay between morality and law is again raised by the M.P.'s characterization of the franchisor as "evil." *Id.* Interestingly, this has roots in Western jurisprudence: in *Nichomachean Ethics* Aristotle said that when "an injury is done from choice, the doer is unjust and wicked." ARISTOTLE, BOOK FIVE OF NICHOMACHEAN ETHICS sec. 8 (David Ross trans., Oxford Univ. Press 1998). The Supreme Court noted that the purpose of antitrust laws is to limit "rights which may be pushed to evil consequences, and therefore restrained." Standard Sanitary Mfg. Co. v. United States, 226 U.S. 20, 49 (1912) (the same argument can also be made for franchise relationship laws).

786. Head v. Inter Tan Can. Ltd., 1991 O.R.3d. 192 (1991).

787. Hardee's assistant director of legal affairs Dave Gordon *quoted in* BRADACH, *supra* note 124, at 34-35.

788. Milford Prewitt, *CKE's 2Q-Loss Grows, but Hardee's Wins Slight Gain; Turnaround Forseen*, NATION'S RESTAURANT NEWS, Sept. 24, 2001, at 4, 74.

789. *See*, Barkoff, *supra* note 140.

790. Amy Garber, *Franchisee's $16.5M Legal Win Over McD Sparks Furor: Judgment Could Fuel more Litigation, Regulation*, NATION'S RESTAURANT NEWS, June 9, 2003, at 1 (quoting Mitchell Shapiro of Jenkens & Gilchrist, speaking on behalf of the IFA).

Star Chamber.[791]

It is by no means certain that a jury in the franchisor's hometown would favor a franchisee from another part of the country. Moreover, the only reason why the jury would hear the case in the first place is if the franchisor's legal affairs officer chose not to put an arbitration clause in the franchise agreement; franchise jury trials, one franchisor lawyer noted, are "a rare but scary thing."[792] Even if the franchisor's case is devoid of legal merit and the franchisee's case is meritorious, the franchisee must incur expensive legal fees to vindicate his rights. Prospective franchisees too often rely on the friendly franchisor salesman. And ignore the economic import of forum selection. One Minnesota franchisee investing $70,000 in a yogurt franchise (and producing evidence of a total loss of $177,000) was awarded $70,000 by an Arkansas jury.[793] The trial court awarded $95,363 in attorneys' fees based not on Minnesota attorney rates but the lower Arkansas rates.[794] On appeal, the court upheld the Arkansas rates but remanded the award of $3990 in costs: the franchisee had incurred in excess of $25,000 due primarily to the expense of litigating in a distant forum.[795] Even franchisors with huge amounts of disclosed litigation are able to sell franchises.[796] The disclosure document may not even be an accurate picture of litigation involving the parties that the franchisee will be dealing with: Actions brought by the franchisor against franchisees do not have to be disclosed, and actions brought by entities allegedly not parties to the agreement do not have to be disclosed. If a suit involves a

791. Contrary to popular belief, prior to the Civil War, the Star Chamber was not always harsh. *See* CLAYTON & DAVID ROBERTS, A HISTORY OF ENGLAND: PRE-HISTORY TO 1714, at 230-31, 356 (1980).

792. Dunham, *supra* note 778. Dunham notes that the prospect of facing juries has affected franchise contracts, and that arbitration clauses are "one explanation for the paucity of jury trials," as in the period 1990-2000 Dunham could only locate 105 jury verdicts. *Id.* at 180. Dunham is the outside counsel for Subway Sandwiches' franchisor, Doctor's Associates Inc. When Subway franchisees obtained an arbitral ruling that the franchisor had attempted to prevent the election of certain franchisees to the Ad Fund board and were awarded costs, punitive damages, attorney fees and the costs of the arbitration, several commentators noted the irony of the franchisor who had championed arbitration as a shield losing in arbitration. *See, e.g., Legal Updates*, FRANCHISE TIMES, April 2001, at 41.

793. TCBY Sys., Inc. v. RSP Co., 33 F.3d 925, 931 (8th Cir. 1994).

794. *Id.* at 928, 931.

795. *Id.* at 931.

796. One of the more improbable claims made by a franchisor consultant is that franchisors with much litigation against franchisees will present that as a "positive attribute" to purchasers "and, as a result, many franchisees may hear about franchisor initiated lawsuits even if said litigation is not disclosed in the UFOC." Letter from Carl C. Jeffers, President, Intel Marketing System, to Federal Trade Commission (undated), *available at* http://www.ftc.gov/bcp /franchise/comments/116jeffe.htm (last visited March, 2003).

real estate or leasing corporation legally distinct but the *de facto* alter ego of the franchisor, that suit should be disclosed. If a franchisee is placed on "probation" or "pre-arbitration" and monetary sanctions attend to such status, that should be a UFOC disclosure as well.

Franchisees should remember that the marginal cost of a legal action is far less for the franchisor, which pays attorneys and paralegals who need only cut-and-paste from the lawsuit/arbitration papers they have on file. Indeed, franchisors may benefit from bringing demands for arbitration or initiating a lawsuit: First by charging the franchisee a cost-plus-overhead fee and second by making it clear to the franchisee that there is no option other than selling the franchise to a buyer of the franchisor's choice. In one case, a court found that "litigation itself has been used by [franchisor] as an instrument to drain [franchisee] for purposes of ultimately buying [franchisee stores] at an inadequate price."[797]

Franchisors and regulators trumpet "transparency,"[798] while at the same time resisting requirements that franchisors disclose all disputes with franchisees. The presence of mandatory arbitration clauses requiring franchisees to travel to distant forums result in franchisees not pursuing valid claims and counterclaims against franchisors. Franchisors can therefore bring action against vast numbers of franchisees and only disclose those that result in a franchisee counterclaim. One franchisor attorney noted:

> To the extent that franchisees sued by their franchisors feel that they have somehow been aggrieved, they will assert counterclaims which will be subject to UFOC Item 3 disclosure in any event. To the extent such franchisees do not feel aggrieved and thus do not interpose counterclaims, we respectfully submit that disclosing franchisor-initiated litigation would furnish no useful information to prospective franchisees but would prejudice franchisors in the manner indicated above.[799]

Disclosing all arbitration actions brought and threats of litigation or termination is important because franchisor coercion is nearly impossible to discern from a UFOC, and franchisees seeking to exit the system are not likely to tell the prospect: "This is an abusive franchise system. How about buying my franchise so I can get out?" Unless the franchisee

797. Photovest Corp. v. Fotomat Corp., 1977 U.S. Dist. LEXIS 15832, at *95 (S.D. Ind. May 18, 1977).

798. Kaufmann, *supra* note 22 (quoting New York State Attorney General Spitzer).

799. Letter from David J. Kaufmann, attorney, to Federal Trade Commission (May 11, 1997), *available at* www.ftc.gov/bcp/franchise/comments/kaufma33.htm (last visited March, 2003).

files a counterclaim, the arbitration will remain undisclosed and not detectable by a search of litigation records. Threats of litigation/arbitration are not disclosed, although they are of major importance to a prospective franchise purchaser. In 1998, Congress passed the Alternative Dispute Resolution Act (ADRA), permitting courts to require litigants to undergo mediation.[800] ADRA does not permit courts to compel arbitration, but many franchisors avoid courts altogether by use of a pre-dispute arbitration clause in the franchise contract.

D. Arbitration Clauses Can Encourage Abuse

An employee in the legal department of one franchisor was particularly proud of the rise in arbitration claims her system is bringing against franchisees, grinning while she said: "[M]y boss doesn't negotiate with franchisees anymore. It's just like hey there's a problem, file an arbitration."[801] Franchisors that have fought franchisees all the way to the Supreme Court (Burger King in 1985[802] and Subway in 1996[803]) did so over the right to compel the franchisee to resolve the dispute in a distant forum. In 1972, the U.S. Supreme Court held that forum selection clauses in commercial contracts are prima facie valid.[804]

For franchisees, justice can be limited to those who can afford to travel across the country and hire teams of lawyers in multiple states. The U.S. Supreme Court,[805] the Court of Justice of the European Communities,[806] and the Ontario Superior Court of Justice have all ruled that a franchisee may be compelled to resolve franchise disputes in a foreign nation. Conducted in secret and not bound by *stare decisis*,

800. 28 U.S.C. §§ 651-58 (2001).

801. *See generally*, *Arbitration In Franchising: A Symposium*, 22 FRANCHISE L.J. (2002).

802. Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985).

803. Doctor's Assoc. Inc. v. Casarotto, 517 U.S. 681 (1996). (Subway sought to compel Montana franchisee to arbitrate before the American Arbitration Association in Bridgeport, Connecticut). Subway has a history of litigation to enforce arbitration in Bridgeport, Connecticut. *See* Doctor's Assoc., Inc. v. Distajo, 107 F.3d 126 (2d Cir. 1997); Doctor's Assoc. v. Hamilton, 150 F.3d 157 (2d Cir. 1998); Doctor's Assoc. Inc. v. Stuart, 85 F. 3d. 975 (2d Cir. 1996); Doctor's Assoc. Inc. v. Hollingsworth, 949 F. Supp. 77 (D. Conn 1996).

804. Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 10 (1972).

805. *See* Mitsubishi Motors Corporation v. Soler Chrysler-Plymouth Inc., 473 U.S. 614 (1985).

806. Benincasa v. Dentalkit Srl, EU Case C-269/95, 1997 WL 1704753, at ¶52 (Eur. Ct. Just. Feb. 20, 1997) (inferior position of franchisee not relevant to determination of validity of forum selection clause). The franchisee unsuccessfully argued that since he never did business as a franchisee, he should be given the protection of consumer law. *Id.*

arbitration raises significant policy concerns, as one judge noted: "There is no verdict, no appeal, no precedent."[807] Franchisors may take advantage of an entire class of franchisees without fear of being called to account for their actions or even to face the reputational damage that a suit would bring, as a franchisor attorney explained:

> [T]he franchisor with an arbitration clause should be able to require each franchisee in the potential class to pursue individual claims in separate arbitration. Since many (and perhaps most) of the putative class members may never do that, and because arbitrators typically do not issue runaway awards, strict enforcement of an arbitration clause should enable the franchisor to dramatically reduce its aggregate exposure.[808]

Filing arbitration claims (with fees charged to the franchisee) has become a franchisor management tool—management by threat. The franchisee may not even understand what is going on: the authors met one franchisee who had been subject to an "arbitration by mail" in which the franchisor filed a claim and debited the franchisee's bank account. The franchisee did not file a response, and lost the arbitration. Meanwhile, the franchisee had complied with the franchisor demand. But the franchisee did not even understand that there had *been* an arbitration, and asked the franchisor to please reverse the arbitration fee since he had fixed the problem. The franchisor contact said she had to get permission to reverse any charge. The charge was never reversed, and the franchisor never explained to the franchisee what had happened.

A lawyer without franchise experience may find it incredible that someone could fail to appreciate the consequences, let alone the existence, of a legal proceeding. In a judicial proceeding, there are strict rules of procedure requiring the service of rather intimidating legal documents on the defendant. The format and presentation of the documents are calculated to impress upon even an illiterate that something important is going to happen.[809] Moreover, the defendant may

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807. Hope Viner Samborn, *The Vanishing Trial*, ABA. J., Oct. 2002, at 24, 26 (quoting E.D. La. District Judge Sarah S. Vance).

808. Edward Wood Dunham, *The Arbitration Clause as Class Action Shield*, 16 FRANCHISE L.J. 141 (1997). *Cf.*, Ting v. AT&T, 182 F. Supp. 2d 902, 920-21 (N.D. Cal. 2002) (arbitration clause's "principal purpose was to put sufficient obstacles in the path of litigants to effectively deter" consumer claims). *Ting* also concerned with the secrecy of arbitral process. *Id.* at 932. For critique of Dunham's position on arbitration, *see* Jean R. Sternlight, *Protecting Franchisees from Abusive Arbitration Clauses*, 20 FRANCHISE L.J. 45 (2000). This trend is spreading to other areas of the law, *see* Scott S. Megregian & Todd Babbitz, *The Use of Mandatory Arbitration to Defeat Antitrust Class Actions*, ANTITRUST, Summer 1999, at 63.

809. Many franchisees are immigrants who may not understand the import even of some legal documents. This author is aware of one franchisee who received a court

also get a letter or postcard from the Clerk of Court notifying the defendant to appear. Even the size of type and exact language of the documents may be mandated by statute.[810] This is a reflection of the strong public policy that one whose rights are at stake should be adequately informed as to the seriousness of the proceeding. Public policy unfortunately is virtually never grounds for overturning an arbitrator.[811] A franchisee may simply receive a letter by certified mail from the franchisor on the franchisor's letterhead, followed by a letter from the arbitral body. Blue-backs, red-lined paper and process servers are frightening to the uninitiated, but they get the point across that something serious is at stake. This author is aware of franchisor representatives who have conducted formal training for their franchisees on what to do when the franchisee receives arbitration demands; the representatives were concerned that franchisees were failing to appreciate that they could lose their entire investment if they didn't properly respond to the franchisor letter. This is particularly true in the case of new franchisees who got the thick UFOC and were told by the franchisor salesperson that the UFOC was a bunch of legal mumbo-jumbo that the FTC and the company lawyers made the salesperson give out.

The authors have met many franchisees who believe that in order for the company to take their business from them, a lawsuit would be necessary. They are surprised to learn that a private company chosen by the franchisor can hold a meeting in the franchisor's hometown and take away the property which they paid for. They protest that if the franchisor ever tried this, a court would stop the franchisor, and do not comprehend the finality of an arbitration. The authors have experience in the

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summons which properly comported with Article 18-A of the New York City Civil Court Act. In that case, the immigrant franchisee referred to the summons as a "letter" and believed the Plaintiff (a vendor) who said the matter was fixed and there was no need to go to court. The Plaintiff then went to court and obtained judgment after a perfunctory inquest at which the franchisee did not appear. It turned out that the judgment was for work performed at a different business which was not owned by the franchisee and not in any way the franchisee's responsibility.

810. *Cf.* N.Y. MENTAL HYGIENE LAW § 81.07(c) (order to show cause must have on its face specific language in 12 point type or larger bold face type).

811. N.Y. Corr. Officers & Police Benevolent Ass'n. v. State, 704 N.Y.S.2d 910, 914 (1999) (arbitration award could not be vacated on public policy grounds since this would invade province of arbitrator and be inconsistent with choice of forum; award must violate "well-defined constitutional, statutory, or common law of this state"). In a more notorious case, the Court refused to overrule an arbitrator's decision to permit a truck driver to continue to drive large trucks on public highways after twice being caught on a random drug test. *See* E. Associated Coal Corp. v. United Mine Workers of Am., 531 U.S. 57, 62 (2000). The court dismissed the employer's public policy argument: in order to invalidate an arbitral award, the public policy must be "explicit, well-defined and dominant." *Id.* This will be small comfort if the pot-smoking driver ever kills someone.

franchise industry and the financial services industry, both of which use pre-dispute arbitration clauses as a risk management tool.[812] On multiple occasions in both industries, the signer of the arbitration clause did not understand that they were waiving their right to bring suit. One of the authors attended a CLE course at which *attorneys* in the audience used the terms "arbitration" and "mediation" interchangeably, when queried one responded that she used the term "binding arbitration" to distinguish from "arbitration"; the lawyer explained that only the latter could be appealed for a trial on the merits. In another instance known to the authors, a Professor of Business at a major state university was not aware of the exceedingly limited grounds for overturning an arbitral decision nor of the differences in discovery. In Civil Court of New York County, commercial disputes are sent to a process referred to as "arbitration" from which a party can appeal for a trial *de novo*—the *court* does not properly distinguish between the terms "arbitration" and "mediation." The head of the American Association of Franchisees & Dealers supports the National Franchise Mediation Program, but notes that many franchisees confuse mediation and arbitration.[813]

Franchisees are not alone in misunderstanding the seriousness of arbitration and its qualitative deficiencies.[814] It would be difficult to conceive of a high court decision that a judge could be improvident or silly, yet the Supreme Court has said that the arbitrator may be "improvident, even silly."[815] "[F]actual errors" are not grounds for judicial review of the arbitrator's decision.[816] Even "the fact that 'a court is convinced [the arbitrator] committed serious error' does not suffice to

812. A major difference is that while a franchise arbitration generally requires the weaker party to travel to the forum mandated by the stronger party, the NASDR sets the forum near the investor's residence and the brokerage firm is required to travel to the arbitration.

813. *Mediation: Is everyone on the same page?*, FRANCHISE TIMES, May 2001, at 56, 57.

814. On deficiencies of arbitral process, *see State high courts skeptical of mandatory arbitration*, DISP. RESOL. MAG., Summer 2002, at 30. This article discusses consumer arbitration cases from West Virginia, Virginia, California, and Montana, but also notes a Georgia commercial case wherein the court stated that because "manifest disregard of the law" is not a statutory ground for overturning an award, the award must stand. *See* Progressive Data Sys. v. Jefferson Randolph Corp., 2002 WL1517841 (Ga.). Arguments on both sides of the debate were made at a Duke Law School symposium. *See The Coming Crisis in Mandatory Arbitration: New Perspectives and Possibilities*, *at* www.roscoepound.org/new/symposiumschedule.htm (last visited May 21, 2004).

815. Major League Baseball Players Ass'n. v. Garvey, 532 U.S. 1015, 509 (2001) (citing Paperworkers v. Misco, 484 U.S. 29, 39 (1987)). One commentator observed that we are witnessing the "transformation of arbitration into arbitrariness." Robert E. Shapiro, *Efficient Injustice*, LITIG. 59, 61 (Fall 2001).

816. *Garvey*, 532 U.S. at 509 (citing *Misco*, 484 U.S. at 36).

overturn his decision,"[817] nor does the arbitrator pleading guilty to criminal tax fraud invalidate the decision.[818]

An October 2001 trilogy in the San Francisco *Chronicle*[819] is credited with prompting the Judicial Council of California to issue *Ethical Standards for Neutral Arbitrators in Contractual Arbitration*.[820] California's temerity brought lawsuits from the New York Stock Exchange and the National Association of Securities Dealers.[821] When the American Bar Association's Section of Dispute Resolution solicited comments on the California standards from three Section members, all acknowledged the abuses in consumer arbitrations.[822] *Ticknor v. Choice Hotels International Inc.*[823] found that a franchise contract agreement to arbitrate was unconscionable under the same state law principles as applied to consumer disputes, but most courts are more willing to uphold arbitration provisions in franchise contracts of adhesion as opposed to consumer contracts of adhesion. As arbitration has spread to the consumer sector, the inherent flaws of the arbitral process have led proponents of arbitration to seek to distinguish "consumer" from "commercial" protections:

> Current efforts in California to deal with the issue of 'repeat player' and inappropriate relationships between providers and those who regularly use arbitration in the employment, consumer and health care context have resulted in legislation that is extraordinarily detailed and onerous. It is important that steps be taken to protect all forms of commercial, construction and other forms of negotiated arbitration agreements between parties of equal bargaining power from adverse attempts to resolve consumer protection issues.[824]

If a party does not give up rights by agreeing to resolve disputes in an arbitral forum, a party by definition does not give up a right to a

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817. E. Associated Coal Corp. v. United Mine Workers of Am., 531 U.S. 57, 62 (2000) (quoting *Misco,* 484 U.S. at 38).

818. *See* United Transp. Union v. Gateway W. Ry. Co., 284 F.3d 710, 712 (7th Cir. 2002).

819. Reynolds Holding, *Private Justice: Millions Are Losing Their Rights*, S.F. CHRON., Oct. 7, 2001 at A1; Reynolds Holding, *Private Justice: Can Public Count on Fair Arbitration?,* S.F. CHRON., Oct. 8 at A15; Reynolds Holding, *Judges' Action Cast Shadow on Court's Integrity*, S.F. CHRON., Oct. 9 at A13.

820. *See* Task Force Report, *available at* www.courtinfo.ca.gov/reference/documents/adrreprot.pdf (last visited Dec. 2003).

821. NASD Dispute Resololution, Inc., v. Judicial Council of Cal., No. C-02-3486-SC, (Cal. Nov. 12, 2002) (dismissing suit as barred by 11th amendment).

822. *Frame of Reference*, JUST RESOL., Oct. 2002, at 13.

823. 265 F.3d 931 (9th Cir. 2001) (applying Montana law).

824. *Frame of Reference*, *supra* note 822 (quoting Richard Chernick of Los Angeles). *See also* Richard Chernick, *Imposed-Arbitration Reforms Threaten to Stifle Strengths of Commercial Arbitration*, DISP. RESOL. MAG., Fall 2002, at 16.

hearing by an impartial neutral in an impartial forum. Given that even proponents of arbitration are now forced to admit what franchisees have known for years, it is reasonable to mandate that UFOCs and franchise agreements contain disclosure as to the disadvantages that a franchisee has in the arbitral process. Most citizens assume that a judge will not have financial involvement with one of the parties to a case; most citizens assume that a judge will not depend on the grace of one of the parties to remain employed; most citizens assume that judges will be rational and not silly. The fact that none of these assumptions are warranted in arbitration should be disclosed in contracts mandating the use of arbitration, and it should not matter whether the contract is drafted by a corporate HMO or a corporate franchisor.

The law of the United States may be enforced (or not enforced) by a private "judge" working for a private company which may depend for its revenue on the continued patronage of a party opponent.[825] In *Via Fone*,[826] a Kansas dealer of cellular phone service believed that the distributor was violating federal antitrust law and went to federal court seeking enforcement of federal law. The court dismissed the case due to language in the dealer agreement that all "claims . . . and disputes between Dealer and Company, shall be resolved by submission to binding arbitration."[827] The history of the last two decades has been one of increasing receptiveness to privatizing the enforcement of disputes, including the enforcement of alleged violations of federal law. Apart from the philosophical question as to whether laws of the United States should be enforced by private citizens sitting in private judgment, the attitude of the Supreme Court that: "Arbitration agreements allow parties to avoid the costs of litigation"[828] presupposes that (1) the

825. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987); Rodriguez de Quijas v. Shearson/ American Express, Inc., 490 U.S. 477 (1989) (securities law and RICO claims arbitrable by securities industry Self-Regulatory Organization (SRO)). Concern over a "dual justice system" was an impetus behind the 2002 California rules for arbitrators. *See Hearings on SB 475 Before the Assembly Judiciary Committee*, Aug. 21, 2001, at 3, *at* http://info.sen.ca.gov/pub/bill/sen/sb_0451-0500/sb_475_cfa_20010820_095918_asm_comm. html (last visited Dec. 2003). The earliest case upholding the constitutionality of the Federal Arbitration Act of 1925 (now codified at 9 U.S.C. § 1 *et. seq.*) was Marine Transit Corp. v. Dreyfus, 284 U.S. 263 (1932). However, courts remained uncomfortable with, if not hostile toward, the FAA until the mid-1980s. Courts will occasionally refuse to enforce an arbitration clause on grounds of procedural unconscionability, particularly in the employment context. *See* Murray v. United Food & Commercial Workers Int'l. Union, 289 F.3d 297 (4th Cir. 2002) (employer picked arbitrator pool and could disregard result); Hooters of Am. Inc. v. Phillips, 173 F.3d 933, 938 (4th Cir. 1999) (noting rules "so one-sided that their only possible purpose [was] to undermine the proceeding").

826. Via Fone, Inc. v. W. Wireless Corp., 106 F. Supp. 2d. 1147 (D. Kan. 2000).

827. *Id.* at 1149.

828. Circuit City Stores, Inc. v. Adams 532 U.S. 105, 123 (2001).

wronged party can afford to seek justice in a distant forum and (2) arbitration is less costly than litigation. Both suppositions are questionable.[829] Arbitration can be, well, arbitrary: there is no requirement for a reasoned decision, and the expense can effectively eliminate remedy for an aggrieved but impoverished party. For many franchisees faced with such a cost-benefit analysis, pursuing remedies against their franchisor would not be economically feasible. Such use of arbitration clauses has significance far beyond franchising and raises issues transcending the wealth of the party: "it is just as much an obstacle to the wealthiest member of society as it is to the pauper."[830]

Moreover, the franchisor may bring action which the franchisee is unable to afford to defend. In a recent construction arbitration, the respondent claimed financial inability to pay the arbitration fees, which were $7,250 per day.[831] The American Arbitration Association panel learned of this after conducting five days of hearings, and ruled that only the petitioner could present evidence thenceforth, and the arbitrators would only consider petitioner's evidence in rendering a decision.[832] Subsequently, a court overturned the award when the petitioner sought judicial confirmation, noting that the denial of respondents rights "was grounded in misconduct" since it was a reaction to respondent's nonpayment of AAA fees, "a matter in which [the arbitrators] had a direct financial interest."[833] The financial interest of arbitral bodies in keeping corporate clients happy has been dealt with elsewhere; suffice it to say that a leaked AAA memo sent to arbitrators in January 2000 asked the arbitrators to assist the AAA "marketing effort for 2000" by soliciting corporations, even to the extent of making a joint phone call (arbitrator and AAA salesman) to the target corporation.[834]

Expensive arbitration as a shield from accountability has been a traditional tactic of franchisors, and is spreading throughout the private sector with troubling results, as one attorney noted: "My last arbitration [involved] a mid-level executive, and it cost us $20,000 for five days of hearings and the filing fee. The court filing fee is $150, and the judge doesn't cost you anything."[835] A recent eight-day JAMS arbitration

829. Public Citizen, *Cost of Arbitration: Executive Summary*, *available at* www.lawmemo.com/arb/res.cost.htm (last visited June, 2003).

830. Leonard v. Terminix Int'l. Co., 854 So.2d 529, 537 (Ala. 2002).

831. Coty, Inc. v. Anchor Constr. Inc., 2003 N.Y. Slip Op. 50013(u), (N.Y. Sup. Ct. Jan. 8, 2003).

832. *Id.*

833. *Id.* at 23.

834. Cliff Palefsky, *Only a Start: ADR Provider Ethics Principles Don't Go Far Enough*, DISP. RESOL. MAG., Spring 2001, at 18, 21.

835. John Gibeaut, *Detoured to ADR*, 87 A.B.A. J. 50, 52 (Oct. 2001). Some analysts disagree. *See* www.arbitration-forum.com/articles/html/delikat-01.asp (last visited Feb.

brought by a Merrill Lynch client cost $80,000 for *each* side.[836] Outside of the United States, however, arbitration can result in a significant savings in legal fees due to the high cost of lawyers in some countries.[837] Even the arbitration-amenable Supreme Court acknowledges, "existence of large arbitration costs could preclude a litigant . . . from effectively vindicating her federal rights in the arbitral forum."[838] The arbitral body also derives revenue due to the franchisor's choice to specify the arbitral body as the sole forum for dispute resolution. The franchisor may then enforce the arbitral award in the courts of the franchisee's home state.[839]

In addition, the franchisor remains able to obtain the benefits of being a "repeat player" since the arbitral forum is generally the franchisor's hometown and the arbitral body is one selected by the franchisor. Even the co-chair of JAMS' Committee on Professional Standards & Public Policy acknowledged that:

> Unless a system is established to provide equal information to all parties, the institutional litigant may be more familiar with the particular process and available neutrals. Moreover, the provider organization and the neutral may anticipate receiving more assignments from the institutional party.[840]

The Supreme Court has held that a franchisor may require arbitration in a distant forum—even an overseas forum[841] operating under foreign rules—and will enforce a foreign arbitration against

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18, 2004) (noting individuals fare better in arbitration than federal court).

836. *See* Sylvia Hsieh, *Merrill Lynch Liable For $7.7 Million For Not Protecting Family's Investments*, LAW. WKLY. USA, Oct. 14, 2002, at 20.

837. *See* Martha Neil, *Small World Big Business: International Arbitration Has Become a Lucrative Field After Decades of Disfavor*, 88 A.B.A. J. 28 (Sept. 2002) (Chicago litigator Hugh R. McCombs, Jr. says his fees less than British barristers, and that arbitration can be handled by one lawyer rather than hiring a barrister and solicitor.).

838. Green Tree Fin. Corp.-Alabama v. Randolph, 531 U.S. 79, 90-92 (2000). *See also* Bradford v. Rockwell Semiconductor Sys., Inc., 238 F.3d 549, 555 (4th Cir. 2001) ("[I]nquiry necessarily turns in part upon . . . whether the forum fees in a particular case are so prohibitively expensive as to deter arbitration." Of course, this does not address the ancillary costs (travel, local counsel, etc.) or the informational imbalance between the repeat-player franchisor and the novice franchisee.).

839. *But see* Artrip v. Samons Constr., Inc., 54 S.W.3d 169, 171 (Ky. App. 2001) (Ky. App. 8/17/2001) (Kentucky law says courts may confirm arb award only when agreement provides "for the arbitration itself to be in the Commonwealth.").

840. Michael D. Young, *The Right Balance: Provider Principles Mitigate the Potential Dangers of Mandatory Arbitration*, DISP. RESOL. MAG., Spring 2001, at 18, 19.

841. *See* Mitsubishi Motors Corp., 473 U.S. at 638-39. With the exception of *Mitsubishi*, most early cases dealing with mandatory arbitration involved stockbrokers. The earliest franchisor to aggressively use arbitration in a distant forum as a weapon against franchisees was Doctor's Associates Inc. (DAI), the Subway sandwich franchisor. *Cf.* Doctor's Assoc. Inc. v. Casarotto, 517 U.S. 681 (1996). Not coincidentally, a joint *amicus* brief was submitted by the franchisors (IFA) and securities firms (SIA) in *Casarotto*. *Id.* at 688.

domestic assets of the losing party.[842] Arbitration can be particularly useful to franchisors wishing to enforce judgments overseas, since more than 100 nations will recognize foreign arbitral awards.[843] That recognition is not found when seeking to enforce court judgments. For example, Turkey is a signatory to the New York Convention (and recognizes arbitral awards) while requiring reconsideration of foreign court judgments.[844] In the U.S., the winning party in a foreign arbitration may be able to enforce the arbitration under the New York Convention, or convert the arbitral award to a money judgment and proceed in the U.S. under the Uniform Foreign Country Money Judgments Recognition Act; the latter choice may enable a monetary recovery even where defects in arbitral proceeding itself may preclude enforcement in the U.S. under the New York Convention.[845]

Contractual unconscionability in the U.S. is judged by the position of the parties at the time of contract signing.[846] The result of current case law is that an individual with little or no business experience may sign a franchise contract eliminating the franchisee's right to seek judicial redress locally. If the franchisor has managed to extract the maximum amount of wealth from the franchisee, the franchisee may lack the resources to arbitrate. This is disturbing enough when the dispute is contractual. Moreover, when the allegation is of a violation of law, to effectively shut off recourse to justice enables the franchisor to violate the law with impunity. Despite evidence to the contrary, the U.S. Supreme Court holds that:

> By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute, it only submits to their

842. Federal Arbitration Act, 9 U.S.C. § 201 (2003) (enacting United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 21 U.S.T. 2517 (June 10, 1958). Pursuant to the Convention, the winner may attach assets in any signatory nation. *See id.*

843. *See* Martha Neil, *Small World Big Business: International Arbitration Has Become a Lucrative Field After Decades of Disfavor*, 88 A.B.A. J. 28 (Sept. 2002) (treaty as reason for increase in preference for arbitration).

844. *E.g.*, U.S. FOREIGN & COMMERCIAL SERV. & U.S. DEPT. OF STATE, TURKEYCOUNTRY COMMERCIAL GUIDE (1999), *available at* http://infoservv2.ita.doc.gov/tcc/InternetCountry.nsf/baee3c88ac11f4628525653a0071d106/ (last visisted March, 2003).

845. Ocean Warehousing B.V. v. Baron Metals & Alloys, Inc., 157 F.Supp. 2d 245 (S.D.N.Y. 2001) (applying N.Y. C.P.L.R. 53 (McKinney 2001)). The court noted that such a result would not be obtained where *lex loci* provided that the arbitral award was a self-executing money judgment, such as provided under Japanese law. *But see* Fotochrome, Inc. v. Copal Co., 517 F.2d 512, 519 (C.A.N.Y. 1975).

846. This makes sense since the alternative would enable a party to escape a contract which proved to be a bad bargain.

resolution in an arbitral, rather than a judicial forum.[847]

The truth of that statement depends on what the meaning of "forgo" is. Accepting the dictionary definition of "to relinquish," one must accept that in at least some franchise disputes, a party possessing statutory rights will—due to cost and time constraints—forgo rights which would have been exercised if those rights could be vindicated in the local courthouse. Individual franchisees may be unable to "close up shop" and travel for hearings before an arbitrator in the franchisor's hometown. Furthermore, even a party entering into contract with a full understanding of the costs and disadvantages to arbitration may have no idea that they will forgo their day in court if the franchisor violates federal antitrust or racketeering law. Congressman Jay Dickey, an attorney and former Taco Bell franchisee, explains:

> Now here I was, the sole practitioner in Pine Bluff, Arkansas, trying to run a business, and if I had any dispute at all, that I was giving up venue and jurisdiction to California . . . . And, thank goodness, we didn't have any disputes . . . . I was thinking, well, all they have to do is—we would just have referred this to a court in California, and I am—it is over. It is over for me . . . it put me back on my heels. It would put other people back on their heels. And remember, I was a lawyer at the time.[848]

Resolving disputes in a distant forum can be even worse in arbitration than litigation. The Supreme Court would have aggrieved parties believe the choice between arbitration and litigation is a distinction without a difference. There is a difference, which explains the recent development of clauses giving one of the parties an option to litigate or arbitrate while binding the weaker party to mandatory arbitration.[849] The reality recognized by the *Bolter* court is that arbitration may result in a party unprotected by statutory rights. A Supreme Court that would allow private persons to interpret and enforce antitrust and discrimination statutes is a Court that would allow

847. Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 26 (1991) (employee alleged violation of Age Discrimination in Employment Act (ADEA)). This involved the employee of a stockbrokerage. The securities industry compelled employee arbitration as a matter of course long before such clauses became common in the general workforce. Note that in *Wilko*, the Court held that the agreement to arbitrate *was* a waiver of substantive law and hence not permitted under the Securities Act of 1933, 15 U.S.C. § 14 (1933). *See* Wilko v. Swan, 346 U.S. 427, 438 (1953).

848. *Franchising Relationship, supra* note 49, at 6 (Statement of Hon. Jay Dickey).

849. Courts have split on whether such clauses are lacking in mutuality or otherwise unconscionable and hence unenforceable. *See* Adam M. Nahmias, *The Enforceability of Contract Clauses Giving One Party the Unilateral Right to Chose Between Arbitration & Litigation*, CONSTRUCTION LAW., Summer 2001, at 36.

franchisors to de facto contract around federal franchise legislation. A "race to the bottom" could ensue,[850] with franchisors arbitrating in the forum most amenable to franchisor overreaching. The difficulties of private "justice" go far beyond forum selection. For example, although punitive damages and statutes of limitation may be contractually limited in litigation, judicial decisions are widely published and contractual abuse is a matter of record, which the legislature can address. Such is not the case with private "justice" meted out behind closed doors with no requirement for a reasoned opinion, let alone a published opinion. If franchisors truly favor full disclosure, they should favor publication of all arbitration decisions; in 2003 a bill was introduced in Texas which would make arbitration awards a matter of public record.[851] The vast majority of franchise disputes are resolved through arbitration.[852] As courts reject the notion of implicit confidentiality in arbitration,[853] franchisors may seek to alter franchise agreements to ensure that franchisees and legislators remain unable to see the extent of franchisor actions against franchisees. Mandating UFOC disclosure and publication would reduce the informational disparity between franchisee and franchisor counsel while still preserving the other advantages franchisor counsel possess.

The flexibility and opacity of alternative dispute resolution (ADR) can be a source of strength, particularly where the parties wish to mend the relationship.[854] However, many franchisees are not sophisticated businesspeople; most franchisor sales pitches are based on this premise. Therefore, a more appropriate paradigm might be the evolving jurisprudence of ADR in employee/consumer contracts. A minority of courts have begun to rethink mandatory pre-dispute

850. In response to new California standards for arbitrators, the American Arbitration Association warned that it may discontinue holding consumer arbitrations in the state. Reynolds Holding, *Arbitration Bills on Davis' Desk*, S.F. CHRON., Sept. 5, 2002, at 1.

851. Mark Boyko, *State LegislaturesSsee Flood of ADR Bills in First Quarter of 2003*, DISP. RESOL. MAG., Spring 2003, at 29, 30 (referring to Texas S.B. 997).

852. Dunham, *supra* note 808, at 180. On procedures for franchise arbitrations generally, *see* FORUM ON FRANCHISING, AMERICAN BAR ASSOCIATION (Oct. 10-12, 2001).

853. Bulgarian Foreign Trade Bank Ltd. v. A.I. Trade Fin. Inc., Case No. T 1881-99 (Oct. 27, 2000), (Supreme Ct. of Sweden) (overturning lower court), *in* 13 WORLD TRADE & ARB. MATERIALS 147 (2001). For a discussion of the lower court decision, *see* 14 MEALEY'S INT'L. ARB. REP. 11 (1999).

854. *Cf*, Peter B. Hutt II et al., *Techniques for Resolving False Claims Act Cases Through Mediation*, PROCUREMENT LAWYER, Spring 2002, at 1, 20 ("Both the party and the mediator will typically engage in more candid discussions . . . in the absence of an adverse party . . . mediator can provide . . . frank assessments . . . through ex parte communications. . . ."). In addition, the arbitrator has broad remedial powers. *See* Millicom Int'l. V N.V. v. Motorola, Inc., 2002 U.S. Dist. LEXIS 5131 (S.D.N.Y. Mar. 28, 2002) (arbitrators ordered dissolution, a remedy not provided in the parties' agreement).

employment/consumer arbitration clauses,[855] but it is by no means certain that their unease will carry over to franchise agreements. Since most franchise arbitrations are subject to the Federal Arbitration Act, current Supreme Court solicitude of abusive arbitration clauses presents high barriers to franchisees seeking justice; state courts cannot protect their own citizens.[856] Franchisees proceed at their own risk: "A properly run arbitration system can produce good results, but many arbitration systems are not fair, and there is almost no law that says they have to be fair."[857]

The strongest legislation ever enacted to protect franchisees was passed by the Iowa legislature,[858] primarily due to legislative disapproval of the franchisor practice of requiring Iowa citizens to travel to a distant forum to seek redress.[859] Franchisor ability to force arbitration or litigation in a forum far from the franchisee can place the franchisee at a disadvantage for many reasons other than home court bias.[860] As one scholar observed: "Who's going to hire a lawyer in some city halfway

855. *See* Halligan v. Piper Jaffrey, 148 F.3d 197 (2d Cir. 1998); Montes v. Shearson Lehman Bros. Inc., 128 F.3d 1456 (11th Cir. 1997); Heurtebise v. Reliable Bus. Computers, Inc., 550 N.W.2d 243 (Mich. 1996). Increasing incidence of arbitration has led to Congressional interest according to the American Arbitration Association, which noted that nineteen ADR-related bills were recently introduced. *See Summary of ADR-Related Legislation Introduced during 106th Congress*, DISP. RESOL. TIMES, Oct-Dec 2000, at 3. *See also*, Boyko, *supra* note 851, at 29 (noting 325 proposed bills, and only South Dakota did not see any proposals).

856. This does not keep state courts from trying, particularly in Alabama, Montana, and California. In the recent case of Bolter v. Superior Court, 87 Cal. App. 4th 900, 901 (4th Dist. 2001) the franchisee prevailed. Most recent decisions striking down arbitration clauses are consumer cases. *See* Kloss v. Edward D. Jones & Co., 54 P.3d 1 (Mont. 2002); Mercuro v. Superior Court, 116 Cal. Rptr.2d 671 (Ct. App. 2002). One commentator noted that Alabama's reluctance to enforce arbitration stemmed from a desire "to inflict 'home-cooked justice' on those without power in Alabama courts." Stephen J. Ware, *The Alabama Story: The State's Experience with Arbitration Shows the Connection of Law to Politics and Culture*, DISP. RESOL. MAG., Summer 2001, at 24, 27.

857. David G. Savage, *Justice in Job Disputes*, 87 A.B.A. J. 30 (May 2001) (quoting Lewis Maltby, counsel for National Work Rights Institute).

858. *See* FRANCHISE DESKBOOK, *supra* note 1, at 295-321.

859. GAO 2001 Report, *supra* note 217, at 45.

860. Charles Hynes, District Attorney for Kings County (Brooklyn) tells of the client who traveled out of state with his lawyer. Upon leaving the courthouse at the end of a losing trial, the client asked his attorney to translate the Latin inscription on the façade. Replied the attorney: "It says: Retain Local Counsel." Two construction industry attorneys noted that owners and contractors include forum selection clauses in an "attempt to alter the risk equation by relying on the lower-tier entities' reluctance to travel substantial distances to pursue a lawsuit in a potentially hostile jurisdiction." V. Frederic Lyon & Douglas W. Ackerman, *Controlling Disputes by Controlling the Forum: Forum Selection Clauses in Construction Contracts*, CONSTRUCTION LAW., Fall 2002, at 15. Forum shopping as a litigation tactic to increase the opponent's cost and obtain a home court advantage first became widespread in the early days of tort suits against the railroads. LAWRENCE M. FRIEDMAN, AMERICAN LAW IN THE 20TH CENTURY 260 (2002).

across the country and fly out there for hearings?"[861] The first thing an aggrieved franchisee may learn is that it will be necessary to hire multiple attorneys, thereby substantially increasing the cost of obtaining redress.[862] Although European attorneys are free to cross national borders to represent clients,[863] an American attorney does not have similar flexibility to cross state borders within the United States.[864] Although an attorney may seek *pro hac vice*[865] admission (denial is strictly within the discretion of the state and is not reviewable),[866] the procedure increases costs. Some states also require the attorney to be assisted by local counsel.[867] For a national franchisor represented by one of the mega-firms, this is a significant advantage over a franchisee represented by local counsel.

E. State Law Waiver

If a franchisee is fortunate enough to have enough money left to hire

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861. Sylvia Hsieh, *Plaintiffs Are Finding New Ways to Challenge Mandatory Arbitration*, LAW.WKLY. U.S.A., Feb. 7, 2000, at 1, 21 (quoting Prof. David Schwartz of University of Wisconsin Law School).

862. As franchisors expand globally, one non-franchise case illustrates how complex litigation may become. United Mex. States v. Metalclad Corp., 89 B.C.L.R.3d 359 (Supreme Court of British Columbia 2001) involved a dispute between a U.S. corporation and the Mexican government over the operation of a landfill. The Vancouver, Canada court had to decide which of two provincial laws of British Columbia were to apply in reviewing Mexican adherence to a multilateral treaty affecting the U.S. company. *See id.*

863. Roger J. Goebel, *Liberalization of Interstate Legal Practice in the European Union: Lessons for the United States*, 34 INT'L LAW. 307 (2000) (citing relevant European Community Treaty provisions and case law).

864. American Bar Association, Commission on Multijurisdictional Practice, Public Hearings (Feb. 16-17, 2001), *available at* www.abanet.org/cpr/mjp-trans-discuss.html (last visited March, 2003). *See also*, Charles Wolfram, *Sneaking Around in the Legal Profession: Interjurisdictional Unauthorized Practice by Transactional Lawyers*, 36 S. TEX. L. REV. 665 (1995); Birbrower, Montalbano, Condon & Franc P.C. v. Superior Court, 930 P.2d 339 (1997) (court ruled that out-of-state attorneys could not participate in arbitrations in California. The legislature overturned this decision); Assembly Bill 915, 1998 Cal. Adv. Legis. Serv. 915 (Cal. 1998). A fifty state plus D.C. listing of unauthorized practice statutes is available from the American Bar Association's website. *See* American Bar Association, Center for Professional Responsibility (Mar. 10-11, 2000), *available at* www.abanet.org/cpr/mjp-uplrules.html (last visited March, 2003).

865. Samuel Brakel & Wallace Loh, *Regulating the Multistate Practice of Law*, 50 WASH. L. REV. 699, 700-01 (1975). Proposed revisions to ABA Model Rules of Professional Conduct would loosen the restrictions. *See* Mark Hansen, *Smooth Sailing: House Approves Proposals to Ease MJP Rules with Minimal Debate*, 88 A.B.A. J. 69 (Oct. 2002). Some states have begun to allow temporary practice by out-of-state counsel without a *pro hac* order. Theresa Osterman Stevenson, *States Address Multijurisdictional Practice*, LITIG. NEWS, May 2003, at 12.

866. *See* Leis v. Flynt, 439 U.S. 438 (1979) (no federal right to practice in state unless state bar admission requirements met).

867. *In re* Smith, 272 S.E.2d 834 (N.C. 1981); Duncan v. St. Romain, 569 So. 2d 687 (Miss. 1990).

legal counsel and travel to a distant forum, the franchise agreement may place the franchisee in a legal no-man's land, bereft of state statutory protection. This is particularly important since there is no private right of action for violation of the FTC's Franchise Rule.[868] In drafting the franchise agreement, franchisors normally incorporate a choice of law provision. A franchisee living in State A, operating a store in State B, and litigating under the laws of State C may find that although all three states have franchise laws, none of those laws will protect the franchisee.[869]

In *Burger King v. Austin*,[870] the franchise agreement provided for the application of Florida law. The Atlanta-based franchisee filed a counterclaim alleging, *inter alia*, violation of the Florida Franchise Act.[871] The response of Burger King was that the franchisee could not claim the protection of Florida law; notwithstanding that Burger King itself had required the application of Florida law as a condition of granting the franchise. Burger King had no problem with applying Florida law to protect the franchisor, but claimed the law that protected the franchisee was only to protect "persons . . . doing business in Florida."[872] Since James and Loretta Austin were not doing business in Florida, the Florida statute could not apply; since only Florida law applied, Georgia law could not apply. Since there is no applicable federal franchise legislation, the Burger King position was that there was no franchise statute protecting the franchisee.

The court held that James and Loretta Austin had standing under the Florida Franchise Act. Although noting that the franchise agreement demonstrated that both parties "intended that they be regarded as doing business in Florida. Any other decision would be unjust . . . ."[873] The Court added:

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868. *See* Brill v. Catfish Shaks of America, 727 F. Supp. 1035, 1041 (E.D. La. 1989) (noting criticism that this effectively imposes upon the franchisee a burden of proof on claims involving FTC violations which had to be brought under Louisiana's Unfair Trade Practices Act).

869. *See e.g.*, Dr. Pepper Bottling Co. of Texas v. Del Monte Corp., 1990 U.S. Dist. LEXIS 18748 at *12-13 (N.D. Tex. 1990) (California choice of law did not confer protection of California franchise act where franchisee was Texas domiciliary not doing business in California). While not exactly analogous to U.S. states, European Community members are prohibited from statutorily discriminating against other E.C. nationals; an *Austin*-type situation would be a violation of article 12 (renumbered article 7) of the Treaty of Rome. *See* Phil Collins v. Imtrat Handelsgesellschaft mbH, 3 C.M.L.R. 773 (Court of Justice 1993). As a practical matter, E.C. franchise laws—and contract law generally—could not be tailored to favor the "home team" as some U.S. states have done.

870. *Burger King*, 805 F. Supp. at 1007.

871. FLA. STAT. ANN. § 817.416 (West 2004).

872. *Burger King Corp.*, 805 F. Supp. at 1022.

873. *Id.* at 1023.

> If the Florida legislature had included a phrase that specifically limited the Florida Franchise Act's application to Florida residents or domiciliaries, the Court would not have determined that the Act was applicable to this contract, i.e. the parties' intent in including a choice of law provision in a contract cannot be used to override the clear intention of the legislature.[874]

Many legislatures have done just that: Burger King cited cases limiting extraterritorial application of state franchise laws of Wisconsin,[875] Connecticut,[876] California,[877] and Illinois.[878] The court cited case law holding that the Burger King franchise agreement resulted in depriving some Burger King franchisees of protection under the laws of the franchisees' domicile.[879] The outcome would be that the franchisee would not be protected by any franchise statute: Burger King "would then be obtaining an unfair advantage solely by virtue of a choice of law provision that benefits [Burger King] by ensuring uniform enforcement of its franchise agreements."[880] Federal legislation would alleviate both concerns: the franchisor would have uniform enforcement within the United States, and the franchisee would have some limited protection even if the franchisor managed to strip away all protection afforded by state law. Additionally, states should pass legislation prohibiting the waiver of local franchise acts:

> A franchisor, through its superior bargaining power, should not be permitted to force the franchisee to waive the legislatively provided protection, whether directly through waiver provisions or indirectly through choice of law.[881]

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874. *Id.*

875. Hoff Supply Co. v. Allen-Bradley Co., 750 F. Supp. 176 (M.D. Pa. 1990) (Wisconsin Fair Dealership Law).

876. Power Draulics-Nielsen, Inc. v. Libbey Owens-Ford Co., 1988 WL 31880 (S.D.N.Y. 1987) (Connecticut Franchise Act).

877. Premier Wine & Spirits v. E. & J. Gallo Winery, 644 F. Supp. 1431, 1439 (E.D. Cal. 1986) (California Franchise Relations Act).

878. Highway Equip. Co. v. Caterpillar Inc., 908 F.2d 60 (6th Cir. 1990) (Illinois Franchise Disclosure Act).

879. Scheck v. Burger King Corp., 756 F.Supp. 543, 550 (S.D. Fla. 1991), *on rehearing*, 798 F.Supp. 692 (S.D. Fla. 1992) (Massachusetts Consumer Protection Act not applicable to Massachusetts franchisee using Florida choice of law); Burger King Corp. v. Weaver, 798 F. Supp. 684, 690 (S.D. Fla. 1992) (Montana Unfair Trade Practices Act inapplicable). *See also* Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir.), *cert dismissed*, 528 U.S. 948 (1999).

880. Burger King Corp. v. Austin, 805 F. Supp 1007, 1023 (S.D. Fla. 1992).

881. Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 132 (7th Cir. 1990) (upholding Indiana statute). *Ricoh* was also cited by Flynn Beverage Inc. v. Jos. E. Seagram & Sons, Inc., 815 F. Supp. 1174, 1178 (C.D. Ill. 1993) ("Illinois has a strong public policy in overriding the choice of law provision provided for in the agreement."); *accord*, Winer Motors, Inc. v. Jaguar Rover Triumph, Inc., 208 N.J. Super. 666, 671-72

Ultimately, however federal legislation is necessary, since courts ignore the anti-waiver provisions. In *Carlock*, Minnesota Häagen-Dazs franchisees with a New York choice-of-law clause sought the protection of the Minnesota Franchise Act.[882] The Act rendered void any "condition, stipulation or provision" which took away the franchisee's statutory protection.[883] The New York Franchise Act did not apply to out-of-state franchisees: as *Carlock* observed, this lack of protection is the norm.[884] Leaving the Häagen-Dazs franchisees out in the cold without the protection of *any* franchise law was not repugnant to the public policy of Minnesota: "The franchisee protections embodied in the Franchise Act were offset by the 'powerful countervailing policy' of enforcing the parties' choice of law."[885] In the wake of *Carlock*, the Minnesota legislature amended the Franchise Act to expressly invalidate contractual choice of law provisions which operated to waive statutory compliance, but courts ignore the legislative intent.[886] It is tautological that the purpose of a non-waiver provision in a statute is so that the statute cannot be waived, but franchisees who merely read the statute will find themselves without Franchise Act protection. Waiver of Franchise Acts is distinguished from waiver of Unfair Trade Practices Acts: while the latter statutes arguably may be waived by commercial parties,[887] Franchise Acts—including their non-waiver provisions—are designed to protect a narrowly-drawn class of commercial parties, i.e., franchisees. Courts should not permit waiver of Franchise Act non-waiver provisions. At minimum, franchisors stripping franchisees of statutory protection should be required to explicitly disclose this fact in the Offering Circular.

The *Austin* court's language is reminiscent of *Hartford Electric*. In both cases, the court ultimately hangs its decision on a statutory peg, but

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(App. Div. 1986) (non-waiver "preserve[s] the fundamental public policy of the franchisee's home state where its statutes afford greater protection").

882. Carlock v. Pillsbury Co., 719 F. Supp.791, 809-10 (D. Minn. 1989).

883. *Id.* at 810, citing MINN. STAT. § 80C.21 (West 2004).

884. *Id.*, discussing N.Y. GEN. BUS. L. § 680. As proud as the New York Attorney General is of his efforts to protect franchisees, those efforts do not extend to out-of-state litigants in New York courts. *Compare* Schwartz v. Pillsbury, Inc., 969 F.2d 840, 847 (9th Cir. 1992) (Illustrating the importance of careful drafting, *Schwartz* noted that New York Franchise Act applies to contracts made in New York, and since the Häagen-Dazs agreements stated they "shall be deemed to have been made in the State of New York, County of Bronx" the New York Act applied even though the franchisees, franchised location, and contract signing all took place in California.) (emphasis omitted).

885. *Carlock*, 719 F. Supp. at 810 (quoting Modern Computer Sys. v. Modern Banking Sys., 871 F.2d 734, 740 (8th Cir. 1989)).

886. 62B AM. JUR. 2D *Private Franchise Contracts* § 408 n.57 (1964).

887. First Mut. Inc. v. Rive Gauche Apparel Distrib., Ltd., 1990 U.S. Dist. LEXIS 17547, at *8-10 (MASS. GEN. LAWS ch. 93A §§ 2, 11 could be waived by commercial parties).

in so doing suggests that the franchisor/distributor was acting in an "unfair" manner; indicating discomfort with traditional ("not override express provisions") contractual jurisprudence. Presumably, Burger King had the advice of counsel when drafting the franchise agreement, and was aware of the ramifications—positive and negative—of the choice of law provision. In fact, Burger King's position was that application of that very choice of law provision would effectively deprive the majority of franchisees of statutory protection. Choice of Law was an express provision of the contract, and it resulted in franchisees treated in an unfair but legal manner: reconciling *Austin*'s dicta with traditional contract law we see hints of Lord Hoffman's "beguiling heresy."

Assume that the State of Tufflove has a law that requires contract breach to be witnessed by a busload of tourists from Topeka as a condition precedent to suit and another law that provides that if the tourists from Topeka do claim to witness a breach such testimony will be dispositive. The *drafter* of a contract specifying Tufflove choice of law will have to weigh the likelihood of an opposing party locating said busload of tourists from Topeka. The non-drafting *signatory* of a contract with a Tufflove choice of law provision will be aware of the difficulty of finding the busload of tourists from Topeka, but also aware that if the hurdle is met, the signatory will win an action regardless of the true merits of the case. Both parties will have to weigh the relative merits of Tufflove statutes versus another state's statutes: as Yogi Berra said, "I don't want to make the wrong mistake."[888]

The *Austin* court presumed that Burger King had made the wrong mistake; that the choice of law provision was included for the purpose of bringing all litigation to Florida. Perhaps the court was correct. Nevertheless, it was not necessarily the *only* benefit Burger King anticipated, and even if an express contractual provision results in unanticipated ancillary benefits, would the court imply a provision that effectively negates the express provision? Unlikely, and the *Austin* court admitted as much in footnote 24.

The real reason the court discussed fairness, I submit, is that just as the *Hartford Electric* court was disturbed by the equities, so was the *Austin* court. "Beguiling heresy" it may be, but courts do occasionally go out of their way to indicate in dicta their distaste with franchisor overreaching. Franchisors would do well to remember that legislators would not find equitable appeals by aggrieved constituents to be heresy.

888. Webster's Electronic Quotebase (Keith Mohler ed., 1994) *cited in* Creative Quotations from Yogi Berra, *available at* http://www.bemorecreative.com/one/64.htm (last visited March, 2003).

That is why more than 10% of the House of Representatives co-sponsored the SBFA in 1999.[889]

VI. Regulatory Issues

A. Regulatory Capture[890]

New York Attorney General Eliot Spitzer is noted for his pursuit of securities firms, and holds "the notion that the franchise marketplace is like the securities marketplace in every respect."[891] Echoing the FTC's statement about not having a negative impact on franchise sales,[892] the Attorney General of New York states: "[w]e are here to create an investment climate and a business climate that is friendly, hospitable, and attractive."[893] That is not the priority expressed by Mr. Spitzer in his regulation of the securities marketplace, but it is a priority which caused the state's leading franchisor attorney[894] to compare Mr. Spitzer to Superman.[895] When you are a regulator and the leading attorney in your state who represents the regulated industry has nothing but fulsome praise for your efforts, the possibility of regulatory capture needs to be considered. The two major securities acts were passed in 1933 and '34, in the wake of the 1929 stock market collapse. The acts expanded the scope of liability for issuers of securities, and the trend of implementing regulations has been likewise. There are private rights of action, publicly available filings, and requirements to affirmatively disclose information the non-disclosure of which would constitute misrepresentation. By contrast, the Franchise Rule was passed at a time when franchisors were concerned about heading off passage of relationship legislation (such as existed in the auto and gas franchise arena); the Chairman of the American Assn. of Franchisees and Dealers (AAFD) observed:

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889. *See* The American Franchise Association, www.franchisee.org/legislative.htm#co (listing co-sponsors).

890. *See generally*, Ian Ayres & John Braithwaite, *Tripartism: Regulatory Capture and Empowerment*, 16 LAW & SOC. INQUIRY 435 (1991).

891. Kaufmann, *supra* note 22. Other regulators disagree, finding that "franchise regulation has not matured to the same extent as securities regulation." Sparks, *supra* note 74 (reporting views of Dale Cantone, of Maryland Attorney General's Office, and Steve Toporoff, of FTC).

892. *See infra* note 951.

893. Kaufmann, *supra* note 22, at 7.

894. Kaufmann wrote the New York Franchise Act and went on to found the largest franchisor law firm in the state. He also writes the practice commentaries for the Act as found in *McKinney's N.Y. Statutes*. Kaufmann also co-wrote an article with Attorney General's office Franchise Section Chief Joseph Punturo and was a contributor to Attorney General Spitzer's reelection campaign.

895. Kaufmann, *supra* note 22, at 7.

> It is important to recall that mandated disclosure was negotiated by franchisors to provide a safe harbor to avoid being accused of fraud. The purpose of the FTC Rule was to simply declare that misrepresentation in connection with the sale of a franchise was a fraudulent and deceptive practice covered by the Federal Trade Act. In a compromise with the franchising industry, the FTC agreed to allow franchisors to provide a disclosure statement to distance themselves from "oral representations." In this light, and from the perspective of a franchisee advocate, mandated disclosure (without minimum standards of fairness) created a rule drafted for the protection of the franchising industry and not the consumer.[896]

Regulatory capture is aided by regulators' perception of the franchise industry. States see franchisors as benign contributors to the local economy: the New York State Attorney General's Bureau of Investor Protection & Securities says franchising is "one of the most successful business techniques . . . a fabulous opportunity" to achieve the "American dream."[897] The regulator echoes the theme of the IFA's founder: "Franchising supports the great American dream . . . a road to personal success is driven by individuals who take advantage of this opportunity."[898] One franchisor even titled its program to convert store managers to franchisees the "American Dream Ownership Program."[899]

New York Attorney General Eliot Spitzer personally reassures investors—and misstates the law—stating his "notion" that: "the franchise marketplace is like the securities marketplace in every respect."[900] This is true to the extent that the franchise marketplace and the securities marketplace both provide access to the capital markets. And franchise promoters pitch franchising as an alternative to stock market investment.[901] The regulatory structure is quite different however, and investor protection is commensurately lower in the franchise marketplace than in the securities marketplace.

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896. Letter from Robert L. Purvin, Jr., to Secretary, FTC (May 4, 1997), *available at* http://www.ftc.gov/bcp/rulemaking/franchise/comments/81purvin.htm (last visisted March, 2003) (emphasis omitted).

897. Kaufmann, *supra* note 22 (quoting Eric Dinallo, Chief of the Bureau of Investor Protection and Securities). Spitzer has created a fund-raising committee and is believed to be running for governor. *Gearing Up for 2006*, CRAIN'S N.Y. BUS., Jan. 27, 2003, at 6.

898. James Peters, *Dunkin' Donuts Founder Receives NRN Innovator Award*, NATION'S RESTAURANT NEWS, Oct. 19, 2001, at 60 (quoting William Rosenberg).

899. Dina Berta, *Firehouse Subs Heats Up Managers' Franchise Dreams*, NATION'S RESTAURANT NEWS, Dec. 17, 2001, at 20. This particular program is one case where the franchisor is risking its own money by loaning it to the managers to buy their store.

900. *Id.* (quoting Eliot Spitzer, N.Y. Attorney General).

901. Kristine McKenzie, *IFE Promises Hot Concepts Here and Abroad*, FRANCHISE TIMES, April 2001, at 16 (statement made by the President of International Franchisor Expo, "[p]eople are starting to see that the stock market is not the answer and that they need to invest in themselves . . . an environment conducive to franchising").

Regulators are more solicitous of the concerns of stock market investors, and have exhibited more concern for wealthy stock market investors than immigrant families targeted by franchisors. The contrast between New York's regulation of the stock market and the franchise market is mirrored in Indiana: in 2001 the Securities Commissioner justified moving from a registration state to a mere notice filing state by stating that his office felt that franchise complaints could be dealt with through private rights of action and that Indiana received more complaints involving general securities fraud issues and would redirect resources formerly devoted to franchise registration review.[902] In an article co-authored by the Wisconsin Administrator of the Division of Securities, the position was on franchisors decidedly caveat emptor: "as folks in Wisconsin are fond of saying, the cream rises to the top."[903] Wisconsin's position on penny stock promoters is likely different: In 1996, Wisconsin had made changes similar to Indiana and shifted resources from franchise regulation to supervision of stock brokers, consumer education, and assisting small businesses to raise capital.[904]

Unlike purchasers of stock, franchisees often invest their life savings in pursuit of the "American dream."[905] This paper suggests that Mr. Spitzer's notion should be implemented: the franchise marketplace *should* be more like the securities marketplace. The AAFD Chairman makes a reasonable proposal:

> [T]he Rule in securities disclosures is that all material information known to the seller must be disclosed, and the seller is liable (by private right of action, no less) for misrepresentation . . . . There is no reason why franchisors should not be placed under the same or similar mandate by the FTC franchise rule as issuers of securities have long accepted.[906]

There should be regulation governing not only the delivery of the Offering Circular but in the ongoing relationship. The franchise marketplace should import securities marketplace fiduciary standards, and franchisors should not usurp opportunities of existing franchisees. Just as purchasers of stock can sell the same product purchased, so too should franchisees be permitted to sell the same product purchased:

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902. James L. Petersen, *Indiana Becomes a Notice Filing State*, FRANCHISE L.J., Summer 2001, at 3.

903. James R. Conohan & Patricia D. Struck, *Modified State Disclosure Regulation: The Wisconsin Experience*, FRANCHISE L.J., Fall 2000, at 7.

904. *Id.*

905. *Cf.*, Jacob Bunge, *Franchisee Finds Automotive American Dream*, FRANCHISE TIMES, Sept. 2002, at 21 (Greek immigrants overcome setbacks and ultimately triumph with SpeeDee Oil Change franchise).

906. Purvin, *supra* note 180 (emphasis omitted).

restraints should be placed on the ability of franchisors to unilaterally alter the obligations of franchisees (and hence, the resale value of the franchise). Just as the securities industry cannot wantonly dilute shareholder investment, the franchise industry should not dilute franchisee investment by means of encroachment. Just as purchasers in the securities marketplace may bring suit in their local courts against rogue corporate fiduciaries, so too should franchisees have that ability. Just as shareholders can utilize class action suits to remedy corporate malfeasance which would otherwise go unpunished, so too franchisees should have the ability to act.[907] As states have reduced their regulation of the franchise industry, the industry practice of mandating arbitration in distant fora and then barring class actions is troubling. As the Supreme Court noted:

> The aggregation of individual claims in the context of a classwide suit is an evolutionary response to the existence of injuries unremedied by the regulatory action of government. Where it is not economically feasible to obtain relief within the traditional framework of a multiplicity of small individual suits for damages, aggrieved persons may be without any effective redress unless they may employ the class-action device.[908]

Just as investors in the securities marketplace may not have their investment taken without just compensation, so too should investors in the franchise marketplace not have their investments taken away (by means of encroachment or altering the economic obligations of franchisees) without just compensation. Finally, just as regulators such as Mr. Spitzer would not think of being cheerleaders for the securities marketplace, or take a laissez-faire "cream rises to the top" attitude, they should not submit to regulatory capture and neutering in the franchise marketplace. Mr. Spitzer was not compared to the comic book character "Superman" by an attorney for the securities industry, but by an attorney for the franchise industry.[909] New York regulators may wax nostalgic for the "American Dream," but a New York Congressman observed: "As

907. Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will The Class Action Survive*, 42 WM. & MARY L. REV. 1 (2000) (arguing for legislative action to protect access to class action remedy); Jean R. Sternlight, *Should an Arbitration Provision Trump the Class Action? No: Permitting Companies to Skirt Class Actions Through Mandatory Arbitration Would be Dangerous and Unwise*, DISP. RESOL. MAG., Spring 2002, at 13. *Contra*, ALAN S. KAPLINSKY, ARBITRATION AND CLASS ACTIONS: A CONTRADICTION IN TERMS, (2001).

908. Deposit Guar. Nat'l Bank v. Roper, 445 U.S. 326, 339 (1980). However, the argument that arbitration clauses prohibiting class actions are void has been rejected in Johnson v. W. Suburban Bank, 225 F.3d 366 (3d Cir. 2000), and Bowen v. First Family Fin. Servs., Inc., 233 F.3d 1331 (11th Cir. 2000).

909. Kaufmann, *supra* note 22 at 3, 7.

franchising continues to grow, we hear persistent complaints from franchisees that what, at first appeared to be a door to the American Dream, was fraught with problems inherent in the franchising relationship."[910]

Paradoxically, the multi-billion dollar franchise industry has avoided regulation of post-contractual abuse of mom-and-pop franchisees on the grounds that it would deprive the victims of a chance to enter into the very contracts which permit franchisor overreaching in the first place. The industry has been successful in presenting the proposition that (1) franchisees are small businesspeople, and (2) multinational franchisors provide the key to the "American dream," and (3) the (misleading) impression that the Franchise Rule regulates the franchise relationship:

> Today, the franchise industry is one of the most important and economically significant industries in America . . . there must continue to be some oversight, monitoring and review of the "day-to-day business practices" of the thousands of companies that offer their vision of *The American Dream* to so many aspiring franchisees.[911]

Regulators are deeply concerned about the interests of corporate franchisors: according to the FTC's Steven Toporoff: "[w]e don't want to have a negative impact on franchise sales. We're very cognizant of that."[912] Given the FTC's unwillingness to bring post-sale (Section 5) actions, Toporoff's solicitude for franchisors is especially disturbing. Regulatory capture is an issue in franchise regulation. Capture is a concern in government generally, but Toporoff presents a rather blatant case; Harvey Pitt never made a similar statement about regulation of the securities industry, even if he actually held such a belief. A high school economics student could tell Toporoff that regulation of widgets will have a negative impact on the sales of widgets; the proper question for a regulator is to find an equilibrium which balances the interests of all parties, not to avoid having a "negative impact" on the regulated industry.

Although encroachment is the most contentious issue in franchising today, and one which can ruin a franchisee, the FTC's *A Consumer Guide to Buying a Franchise* does not mention the topic. The only discussion of territory in the 21-page brochure is a single paragraph note that "Franchisors may limit your business to a specific territory" and an

910. *Franchising Relationship*, *supra* note 49, at 2 (statement of Hon. Jerrold Nadler, D-NY).

911. Jeffers, *supra* note 796.

912. Nancy Weingartner, *ABA Forum: Practice Makes Perfect*, FRANCHISE TIMES, Nov. -Dec. 2002, at 12, 13.

explanation that this would benefit the franchisee by protecting them from competition, albeit at the expense of "imped[ing] your ability to open additional outlets or move to a more profitable location."[913] It does not take a salesman to recognize this as a not-so-subtle sales pitch by the FTC: a "negative" premised on franchisee profitability and resultant desire to expand.

Courts are solicitous of the franchise industry position. The more influential the franchise industry becomes in the national economy, the greater the need to give free rein to franchisors:

> Franchising is a bedrock of the American economy. More than one-third of all dollars spent in retailing transactions in the United States are paid to franchise outlets. We do not believe the antitrust laws were designed to erect a serious barrier to this form of business organization.[914]

> Indiscriminate invalidation of franchising arrangements would eliminate their creative contributions to competition and force suppliers to abandon franchising and integrate forward to the detriment of small business.[915]

Imperfections exist in any market. Disclosure does help to reduce informational disparities between franchisor and franchisee, and regulators should be cautious about over-regulating. But to regulate only the pre-sale period and leave post-sale abuses to the corrective forces of an ostensibly "free" market presupposes that a truly "free" market exists. Congressman Dickey, the former Taco Bell and Baskin-Robbins franchisee, notes that as a conservative, he doesn't favor interventionist government but the realities of the franchise industry led him to support some regulation of the relationship.[916] The "Chicago School" posits that government regulation distorts the marketplace and thereby inhibits economic growth. But as Mr. Spitzer himself noted, the Chicago School "has missed some critical points" and "the marketplace does not function without some degree of government intervention."[917] Spitzer went on to

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913. FEDERAL TRADE COMMISSION: A CONSUMER GUIDE TO BUYING A FRANCHISE 4 (1994).

914. Queen City Pizza, Inc. v. Domino's Pizza, Inc., 124 F.3d 430, 441. (3d Cir. 1997).

915. United States v. Arnold, Schwinn & Co., 388 U.S. 365, 387 (1967) (Stewart, J., concurring in part and dissenting in part).

916. *Franchising Relationship*, *supra* note 49, at 7-8.

917. William Rainbolt, *Attorney General's Success Shows Flaw in "Chicago School" Theory*, N.Y.S.B.A. NEWS, March-April 2003, at 34 (quoting Spitzer speech to Judicial Section annual luncheon). What exactly constitutes "Chicago" theory is open to debate: Warren Grimes says that his is "post-Chicago" theory, and that *Kodak* is a "post-Chicago" decision. Warren S. Grimes, *Reply to Editor's Note*, 67 ANTITRUST L.J. 745,

speak of the securities marketplace in terms which might be equally applicable to the franchise marketplace, and the thousands of pages of franchise litigation and franchisor testimony at Congressional hearings:

> We've become more willing to accept the notion of self-regulation, but the problem is that this has been an abject failure [in securities regulation]. In looking at thousands of pages of documents, I can say that no one ever said 'we have a structural problem, we have other problems.[918]

In May 1999 Attorney General Spitzer began referring errant franchisors to the National Franchise Council (NFC) "Alternative Law Enforcement Program"; the NFC is a group of the largest franchisors in the United States.[919] The securities marketplace may be like the franchise marketplace, in which case the "abject failure" of self-regulation will recur, this time in the franchise industry. Meanwhile, permitting a private "Law Enforcement Program" creates an atmosphere not conducive to franchisor self-restraint: franchisees to not have a private right of action under the Franchise Rule, but franchisors have a private right of correction. Spitzer's action was cited approvingly in an *amicus* brief submitted in Texas by the NFC on behalf of a franchisor. Author of that brief is David J. Kaufmann, counsel to the NFC. Kaufmann founded the leading law firm in the country specializing in franchisor representation. In May 1999 his firm donated $500 to Spitzer's re-election campaign.[920]

As a Deputy Attorney General, Kaufmann wrote the New York Franchise Act, and he authors the influential *Practice Commentaries* to the McKinney's Consolidated Laws of New York. As a state regulator, Kaufmann pioneered the regulation of franchisors, drafting a tough disclosure law that remains one of the most comprehensive in the U.S. As a private attorney advocating on behalf of franchisors, Kaufman is politically astute. In an article co-authored with Joseph Punturo, Assistant Attorney General in charge of franchise enforcement, Kaufman wrote:

> New York has gone from "worst to first" nationally when it comes to franchise fraud enforcement activity since Joseph Punturo's elevation to the post of the Attorney General's Franchise Section Chief, the

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746 (2000).

918. *Id.*

919. Brief of *Amicus Curiae*, the National Franchise Council, in Support of the Petition for Writ of Mandamus of Relators GNC Franchising Inc, *available at* www.nationalfranchisecouncil.org/newsctr/briefs/gnc.htm (last visited March 2003).

920. Contributions of May 27, 1999, *available at* www.elections.state.ny.us/finance/contributors.htm.

> election of Attorney General Spitzer, the appointment of his Chief of the Bureau of Investment Protection and Securities, Eric Dinallo, and the appointment of Assistant Attorney General William Estes.[921]

Kaufmann discusses New York's involvement with the NFC in a section of his *amicus* brief. The section is titled "The National Franchise Council's Partnership with Government," and claims that the NFC program is designed "to foster compliance with . . . federal and state laws . . . and in an effort to insure that franchisees enjoy the salutary benefits of same."[922] Kaufmann fails to mention what the NFC itself admits: "NFC hopes to enhance the effectiveness of existing franchise sales laws to protect franchisees *and thereby weaken arguments for intrusive regulation of franchise relationships.*"[923]

If Attorney General Spitzer were referring wayward brokerage firms to "alternative law enforcement" run by Merrill Lynch and Citigroup, his actions with franchisors might be seen as part of his political philosophy. Spitzer's regulatory approach to the franchise industry is remarkable for the contrast to Spitzer's approach to regulation of other economic sectors. There is merit to the argument that franchisee failure to unite and wield the political clout that franchisors possess is the fault of franchisees; legislators respond to well-financed lobbying efforts. Regulatory capture of the "Law Enforcement Program" of a major state is indicative of the power wielded by the franchise industry.

Regulatory capture is not simply a concern at the federal level. With the exceptions of California, Maryland, and Iowa, states have expressed waning interest in regulating franchise sales, let alone the post-sale franchise relationship.[924] As chair of the North American Securities Administrators Association (NASAA), Maryland expressed a preference for uniform state regulation mimicking the FTC model.[925] But Maryland has also recognized the crucial role of regulators in restraining abuse, noting that as franchising continues to evolve so must franchise laws

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921. David J. Kaufmann & Joseph J. Punturo, *Recent Developments in Franchise Law*, N.Y. BUS. L.J., Fall 2001, at 13, 20.

922. *Id.*

923. About the NFC, NFC-FTC Partnership, *available at* www.nationalfranchisecouncil.org/about/about.htm (emphasis added).

924. State filing is required in fourteen jurisdictions: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, Wisconsin. Franchise attorneys have praised the three states that dropped even the registration requirement: Michigan (since 1984), Wisconsin (since 1996) and Indiana (since 2001) now require mere notice filing. Rochelle B. Spandorf, *Exactly Who is Protected by Franchise Registration Anyway*, FRANCHISE TIMES, Sept. 2001, at 47.

925. Weingartner, *supra* note 912 (citing Dale Cantone of the Maryland Attorney General's office).

evolve to protect the consumers who purchase franchises.[926] When abuses in the janitorial franchise sector grew to the point where even the FTC could no longer turn a blind eye, the warning brochure *Buying a Janitorial Services Franchise* posted on the FTC website was actually written by Dale Cantone of the Maryland Attorney General's office.[927]

American regulation of franchising has global effects for two reasons. First, because American franchisors command the bulk of the franchise market and attempt to standardize franchise terms worldwide; as Professor Friedman notes, "If culture and trade globalize, law will almost inevitably follow."[928] Second, the corollary that courts overseas look to American franchise jurisprudence, particularly where the instant franchisor is U.S.-based;[929] although this may change as foreign jurisdictions develop a body of franchise law.[930] Foreign legislators may also look to American legislation: the Japanese Diet has been lobbied by franchisees influenced by "developments in the United States, with much discussion of tying, of encroachment, and of the Iowa [franchise] law"[931]

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926. *FTC Franchise Rule Review: Hearing Before the Subcomm. on Commerce, Trade and Consumer Protection of the Comm. on Energy and Commerce*, 107th Cong. 107-116 (2002) (testimony of Dale Cantone).

927. Julie Bennett, *Brochure Aims to Clean Up Janitorial Franchises*, FRANCHISE TIMES, Aug. 2002, at 5. The author also notes that due to personal guarantees, franchisees who fail can lose their home or car, and many franchisees "disappear" to avoid pursuit by franchisors. *Id.* at 6.

928. LAWRENCE M. FRIEDMAN, AMERICAN LAW IN THE 20TH CENTURY 574 (2002). He might also have added that if franchisors globalize, litigation will follow: famously non-litigious Japanese have become adversarial franchisors/franchisees. *See* Philip F. Zeidman, *supra* note 30. Even Palau now has two American franchisors. *See Pohnpei State Reports Economic Progress*, MICRONESIAN INVESTMENT. Q. (1994). The growth in global franchising is due in part to American firms advertising on the Internet. Press Release, Federal Trade Commission, Growth In International Franchise Sales to be Topic at FTC Workshop (Feb. 13, 1996) *available at* www.ftc.gov/opa/1996/9602/worksh.htm. The U.S. Dept of Commerce also promotes franchising overseas. *See* U.S. Franchising Matchmaker Trade Delegation, *available at* www.ita.doc/gov/doctm/franaus.htm.

929. *E.g.*, Ellis v. Subway Franchise Sys. of Can., [2000] Ont. Sup. C.J. LEXIS 999 (relating to Subway Sandwiches, unconscionability of arbitration in a distant forum, the repeat player advantage of a franchisor, and citing four cases from the U.S. Second Circuit). *See also* Far Horizons Pty Ltd. v. McDonald's Austl. Ltd., 2257 of 1996 (Sup. Ct. of Victoria, Commercial & Equity Division, Aug. 18, 2000) (McDonald's encroachment, citing three U.S. cases); Jirna Ltd. v. Mister Donut Ltd., [1970] 13 D.L.R. (3d) 645, *rev'd*, 22 D.L.R. (3d) 639, *aff'd* 40 D.L.R. (3d) 303 (first franchise case in Canada; American and British cases cited). Also, an English court was invited to examine an American decision involving the Ziebart franchisor, but deemed the case not on point. Paperlight Ltd. v. Swinton Group Ltd. (Q.B. 1998) (Hearing Transcript).

930. *E.g.*, Zvi Tamir, *Franchising, in* ISRAELI BUSINESS LAW: AN ESSENTIAL GUIDE § 7.04 (Alon Kaplan ed., 1996) (as more franchised outlets open, likely that "better legal tools" will be found for franchise litigation). *See also*, Philip F. Zeidman, *Franchising in the Pacific Rim*, FRANCHISE TIMES, Oct. 2001, at 57 (Asian "movement towards more franchise-specific legislation").

931. Zeidman, *supra* note 30.

and a Fulbright scholar left his position at the Tunisian Ministry of Commerce to study franchising in the U.S. in order to "prepare the legal framework" for franchising in Tunisia.[932] The American franchise industry trade group, the International Franchise Association (IFA) has actively sought to ensure that overseas legislation, if any, covers only the brief period prior to the signing of the franchise agreement and not the franchise relationship itself, which can last for a period of 20 years or more. According to a member of the UNIDROIT[933] committee drafting a model franchising law, IFA support is necessary since it is the most influential organization in franchising.[934] The IFA only supported the UNIDROIT effort when it was clear that the model law would not create new impediments to franchisor discretion in the franchise relationship.[935] But as we have seen, franchisor discretion has frequently been abused. To use Attorney General Spitzer's framework, it would be as if the Securities Act of 1933 was the only regulation and the Exchange Act of 1934 did not exist. Just as the securities marketplace could not be effectively regulated under such conditions, neither can the franchise marketplace. Passage of federal franchise legislation will reduce the risk of regulatory capture at both federal and state levels, reminding regulators of their obligation to regulate without fear or favor.

As previously discussed, franchisors often target immigrants and other more vulnerable members of society. Such groups have less money and less organization to protect their interests, even if the collective action problem can be overcome: in economic terms, franchisees are less capable of rent-seeking behavior. Elected officials seek to rise to higher positions in their chosen profession; money and votes are necessary to accomplish this. Although franchisees may have all of their wealth tied up in a franchise and the family member's dependent upon the franchise for their livelihood, franchisees lack the monetary resources of franchisors, both individually and in the aggregate. Immigrant franchisees may not even be eligible to vote, and franchisees working 14-hour days are not likely to devote much time to political activism. One difference between the franchise marketplace and

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932. *Fulbright Student to Study Franchising at St. Thomas*, FRANCHISE TIMES, Oct. 2000, at 10.

933. *See* International Institute for Unification of Private Law, *UNIDROIT Principles of International Commercial Contracts, available at* http://www.unidroit.org/english/principles/pr-main.htm (last visited May, 2004).

934. *Attorneys Get Scoop at Legal Meeting*, FRANCHISE TIMES, June-July 2001, at 4.

935. *Id.* One franchisor attorney who opposes *any* franchise legislation, nevertheless comments favorably on the UNIDROIT Model Law due to the law's lack of regulation of the franchise relationship and extensive limitations on the need for disclosure by franchisors. *See* Mitchell Shapiro, *The Unidroit Model—Pros and Cons*, 4 FRANCHISE L., Winter 2001, at 3.

the securities marketplace is the constituency harmed by opportunistic corporate behavior. When large voting blocks of middle-class New Yorkers were harmed by corporate misbehavior, Attorney General Spitzer did not tell them they could have avoided being harmed by thorough investigation before investing, or that they were foolish to believe the hype of brokerage firm "analysts." Instead, the Attorney General moved quickly to take legal action and appear on national television to ensure that the voters were aware of his concern.

Another way in which the regulatory debate has been slanted is due to the success of the franchisor trade organization in image promotion. In a press release announcing the International Franchise Association (IFA) position on the GAO report, the IFA claims that: "IFA, the only trade group that represents both franchisees and franchisors, was founded in 1960 to promote good franchising practices that protect those who pursue small-business ownership through purchasing a franchised business."[936] The GAO report echoes the IFA's self-proclaimed neutrality: "IFA primarily represents the rights and interests of franchisors and franchisees. IFA represents about 800 franchisor members, 2,000 individual franchisee members, and 30 franchisee associations and councils representing another 30,000 franchised outlets."[937]

Given the 800-32,000 disparity, a reader might actually believe that the IFA is controlled by franchisees when in fact for 40 years the IFA has consistently fought against legislation and filed amicus briefs *opposing* franchisees.[938] Franchisee members of the AFA must pay to belong, but franchisees do not have to pay to belong to the IFA if their franchisor is a member. The IFA's claim to represent franchisees is not regarded as credible by the AFA, whose Director of Public Policy quipped: "What other organization ever let people in just because they're breathing?"[939] A Molly Maids franchisee noted that IFA was trying to boost the number of franchisee members in order to claim that franchisees supported the

936. *Franchise Rule Protecting Franchisees, Government Study Finds*, IFA FRANCHISE NEWS, Aug. 1, 2001, *available at* http://www.franchise.org/news/newsbriefs/08022001.asp. *See also IFA Press Release, Franchise Rule Protecting Franchisers, Government Study* Finds, (Aug. 1, 2001), *available at* http://www.franchise.org/news/pr/08012001.asp (last visited March 2003).

937. GAO 2001 Report, *supra* note 217, at 35.

938. Doctor's Assoc. Inc. v. Casarotto, 517 U.S. 681 (1996) (opposing franchisee interpretation of Montana statute & arbitration); Susser v. Carvel Corp, 380 U.S. 930 (1965); Nieman v. Dryclean U.S.A. Franchise Co., 178 F.3d 1126 (1999) (applicability of Franchise Rule to non-U.S. purchaser).

939. Julie Bennett, *What a difference a Year Didn't Make: Revisiting 2000's 20 to Watch*, FRANCHISE TIMES, Nov.-Dec. 2000, at 28, 29 (franchisees gain Internet access for free but must pay $100 a year to get material in printed form).

IFA's positions.[940] The ability of the IFA to present itself to regulators, legislators, and the media as a balanced "voice of franchising" is a critical component to the success the IFA has had in thwarting regulation of franchising.[941] The ability of the IFA to market itself to the public as a quasi-regulatory organization forestalls pressure for legislation[942] and assists franchisor salesmen, who can purchase (at $625 per thousand) "Membership Verification Letters . . . stating that the [franchisor] meets IFA's membership requirements."[943] The historical revisionism of the IFA was disputed by the founder of the organization, the late William Rosenberg. When a trade publication presented an award to Rosenberg in 2001, it quoted Rosenberg on the reason for the IFA's existence:

> When people got hurt and lost money in a franchise agreement, the first thing they did was to complain to their congressman or state legislator. These guys, not knowing anything about franchising or having any credible source of information, wanted to pass laws that would make it difficult to survive as a franchisor.[944]

The article continued: "*To protect franchisors*, Rosenberg and 18 of his peers gathered at a trade show in Chicago in 1959 to form the IFA."[945] It is more than coincidental that the founding of the IFA coincided with the passage of the first federal franchise legislation (protecting auto dealers)[946] and the imminent threat of additional federal oversight. The 1993 IFA decision to allow franchisees to be elected to the IFA governing board took place as complaints of franchisor abuse caused Congressional pressure to enact federal legislation.[947] One industry observer feels that franchisors will treat franchisees properly

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940. Janet Sparks, *FTC hearings a Nonevent? Not Exactly*, FRANCHISE TIMES, Sept. 2002, at 41.

941. *See*, *Franchising Today*, USA TODAY, Sept. 18, 2002, at 7B (IFA is "Voice of Franchising . . . launched . . . to protect, enhance and promote franchising. . . . During Franchise Appreciation Day Sept. 24, franchisees and franchisors will . . . meet with members of Congress . . . [and] present [the] 'Legislator of the Year' award. . . .").

942. *See* GAO 2001 Report, *supra* note 217, at 25 (IFA chief counsel told GAO that "reliable" indicators of franchise problems were FTC enforcement data and complaints alleging violations of IFA Code of Ethics).

943. IFA PUBLICATIONS, PRODUCTS, AND SERVICES CATALOG: 2003, at 17.

944. *Rosenberg to Receive NRN Innovator Award*, NATION'S RESTAURANT NEWS, Sept. 10, 2001, at 4.

945. *Id.* (emphasis added). The article noted that Rosenberg is "[a] revered name at the IFA . . . honored as its first Hall of Fame Award recipient."

946. Automobile Dealers' Day in Court Act, 15 U.S.C. §§ 1221-1225 (1956).

947. Jeffrey A. Tannenbaum, *Focus on Franchising: LaFalce Gains Allies in House to Halt Franchise Abuses*, WALL ST. J., July 9, 1993, at B2. IFA called "for franchisors to register their franchisees as members of IFA so that they have the power on Capital [sic] Hill to say they truly represent franchising, not just franchisor interests." Nancy Weingartner, *Attendees Benefit from 'Collective Wisdom,'* FRANCHISE TIMES, Mar. 2002, at 18, 19.

since failure to do so will result in "a cancer eating away" at the brand.[948] History has shown that franchisors such as Subway, Dunkin' Donuts, Baskin Robbins, Burger King, and Holiday Inn can survive and prosper notwithstanding poor franchisee relations, massive litigation, and negative media reports in everything from the Wall St. *Journal* to the West hornbook on Antitrust. The reality is that (with the notable exception of Allied Domecq) franchisors have come to present a kinder face because of rising pressure for Congressional regulation of the franchise relationship. A legislative and judicial framework which enables one party to oppress the second party is not conducive to cooperation since the oppressing party knows that its discretion is unfettered. Just as the franchise industry placated franchisees as franchise relationship legislation gained support in Congress, so to will the franchise industry become more amenable to cooperative dispute resolution when the likelihood of courtroom victory is lessened.

It should be noted that the legislation enacted in 1956[949] did not make it "difficult to survive" as an automobile franchisor; cars are still sold in America today. Legislation enacted in 1978[950] did not put gas stations out of business either. Rosenberg did set the tone in 1959 for the IFA as it exists today: "people who got hurt" are not a "credible source of information," but the franchisor members of IFA who get the hurt people's money are the "unified voice of franchising," and not only does the FTC not threaten the survival of franchisors, the FTC states that it doesn't even want its regulations "to have a negative impact on franchise sales."[951].

Application of equitable principles is vital in the absence of federal franchise legislation, since the Federal Trade Commission refuses to regulate the post-sale relationship, despite having authority to do so. Franchisees quickly discover—after they purchase—that the FTC only concerns itself with pre-contractual disclosure and that arbitration clauses preclude lawsuits and class actions are specifically prohibited. But one would not know this from the FTC's answer to the "Frequently Asked" question about filing a complaint, which begins:

> We regret that you're having a problem with a franchisor or business opportunity seller. We'd like to help, but can't guarantee we'll be able to, because the Commission lacks the resources to investigate every individual complaint it receives. For this reason, we urge that

948. Janet Sparks, *Franchisee Associations: They're Not Going Away*, FRANCHISE TIMES, Sept. 2001, at 12. Sparks takes a positive view of franchisee inclusion in IFA. *See "Franchise Inclusion" Takes on New Meaning*, FRANCHISE TIMES, May 2001, at 14.

949. 15 U.S.C. §§ 1221-1225 (1956).

950. 15 U.S.C. § 2801 *et seq.* (1978).

951. Weingartner, *supra* note 912, at 13.

> you also consider talking with a private attorney about the feasibility of bringing a private lawsuit, or taking other individual or group action that may help resolve the problem.[952]

But as the U.S. General Accounting Office (GAO) explained, "In general, only FTC, not private parties, can enforce violations of the Franchise Rule or FTC Act,"[953] and lawsuits can be barred by contractual clauses, as can class-actions. The FTC has consistently taken a position adverse to the small franchisees and in favor of the franchise industry, going so far as to tell the GAO in 2001 that although "FTC's data are not sufficient to assess" the incidence of franchise relationship problems, "the isolated instances of franchise relationship problems do not justify [the] FTC conducting a more widespread investigation,"[954] despite the FTC's 1999 statement that there were "significant" relationship complaints.[955] In 1998, the FTC abdicated a portion of the Commission's duties to a private franchisor group[956] "represent[ing] the rights and interests of large franchisors"[957]—foxes guarding the hen house. Even where staffers conduct an investigation, there is little danger to industry interests: out of 79 investigations which FTC supervisors authorized to be closed without action, 77 were closed without any explanation.[958] Congress must intervene to restore the FTC to its proper governmental role of a neutral regulator.

B. FTC Regulation: Statutory Basis For Enforcement

The FTC has two avenues for franchise regulation. The first, *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*,[959] came into effect in October 1979 and is known as the 'Franchise Rule.' The Franchise Rule is the primary federal vehicle for protection of franchisees and is conceptually based on a disclosure regime. To the extent that the Franchise Rule is the limit of the FTC's vision of regulatory mandate, the regulatory construct fails to acknowledge the reality of relationship contracts. This is a fundamental

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952. Federal Trade Commission, *Franchise and Business Opportunity FAQs*, *available at* http://www.ftc.gov/bcp/franchise/faq1.htm (reviewing FAQ #3, "How can I file a complaint against a company?").

953. GAO 2001 Report, *supra* note 217, at 7. *Accord*, *Franchising Relationship*, *supra* note 49, at 23 (statement of Susan Kezios, President, American Franchisee Assn.).

954. *Id.* at 23.

955. *Id.* at 22 (citing *Franchise Rule*, 64 Fed. Reg. 57,294, 57,296 (1999) (to be codified at 16 C.F.R. pt. 436).

956. *Id.* at 7.

957. *Id.* at 35.

958. *Id.* at 3.

959. Franchise Rule, 16 C.F.R. pt. 436 (1999).

flaw whose importance cannot be overstated if one is to understand the legal climate in which American franchising operates. The Franchise Rule applies for as few as ten *days* prior to the signing of the contract. Unless there is a disclosure violation, the Franchise Rule does not speak to the franchise "relationship"[960] itself—potentially a period of 20 *years* or more. This would not necessarily be a problem in a discrete contract: a 20-year agreement to supply 10,000 widgets per year in return for $10,000 per year is essentially one transaction with little room for contractual discretion by either party. However, a franchise agreement is not a discrete contract, and a lot can happen in 20 years. Furthermore, when courts see nothing wrong with franchisees who lose their life savings due to franchisor encroachment, the need for remedy for relationship abuse is readily apparent.

The second possible avenue for regulation is Section 5 of the FTC Act.[961] This is a statute of broad applicability, permitting the FTC to regulate unfair or deceptive practices. As a practical matter, however, Section 5 is of little use to franchisees. During the period from 1993-2000, the FTC brought six[962] Franchise Rule cases to court against franchisors[963] and fourteen cases involving both Franchise Rule and Section 5 cases.[964] In July 2001, the GAO reported that in the history of the FTC there had only been two pure Section 5 actions, both of which were closed without action. Section 5 was *never* an independent cause of action against any franchisor—*the Federal Trade Commission refuses to regulate purely post-sale conduct despite the existence of statutory authority.*

According to the GAO, this is not an issue for concern:

> Many states have a "little FTC Act"... or some type of general consumer protection or fraud statute that franchisees can use to address contractual disputes. These statutes are referred to in different states, for example, as consumer protection acts, consumer sales acts, deceptive trade practices acts, and consumer fraud acts. The states' franchise relationship laws and other consumer protection or fraud statutes generally allow franchisees to file lawsuits in state courts against franchisors for violations of these state laws.[965]

960. Commonly accepted definition of "relationship issues" is that used by the GAO: "those that arise after the franchise agreement has been signed (i.e., post-sale)." GAO 2001 Report, *supra* note 217, at 2.

961. 15 U.S.C. § 45 (2000).

962. GAO 2001 Report, *supra* note 217, at 49.

963. There were also cases brought against "Business Opportunity" companies, which topic is beyond the scope of this paper.

964. GAO 2001 Report, *supra* note 217, at 52.

965. *Id.* at 44.

Leaving aside that only 17 states have franchise relationship laws and that franchisor-drafted contracts often specify choice-of-law, the "little FTC Acts" may not cover franchisees as a matter of state law. The most frequent barrier to franchisee redress under the Acts is that a franchisee may not be "consumer" and/or the specific issue being litigated may not be a "consumer transaction."[966]

Is the franchise dispute covered by the state little FTC Act? Yes, say courts in Florida,[967] Idaho,[968] and Illinois.[969] No, say courts in Maine,[970] Maryland,[971] New Jersey,[972] and Pennsylvania.[973] Maybe, say courts in New Hampshire (must be enumerated unlawful act and construed in accordance with federal FTC Act),[974] Tennessee (depends on whether franchisee is corporate entity),[975] and Texas (depending on what was purchased and nature of claim).[976] Probably not, say courts in Georgia[977] and Louisiana.[978]

C. GAO 2001 Report

Regulatory enforcement by the Federal Trade Commission is limited in both scope and ambition: compromised by a narrow mandate and succumbing to regulatory capture, the FTC fails to exert the

966. Even when the goods purchased from the franchisor might qualify the franchisee as a consumer, the basis for the complaint must be the goods purchased, not wrongful termination or the like. Americom Distrib. Corp. v. ACS Communications, Inc., 990 F.2d 223, 227 (5th Cir. 1993).

967. Luzim v. Phillips, No. 87 C 112, 1989 WL 30214, at *1 (E.D.N.Y. Dec. 10, 1987) (applying Florida law).

968. Carlock v. Pillsbury Co., 719 F. Supp. 791, 850 (D. Minn. 1989).

969. Scotsman Group, Inc. v. Mid-America Distrib., Inc., No. 93 C 7320, 1994 WL 118458, at *2-3 (N.D. Ill. Apr. 5, 1994).

970. C-B Kenworth, Inc. v. Gen. Motors Corp., 706 F. Supp. 952, 957 (D. Me. 1988).

971. Layton v. AAMCO Transmissions, Inc., 717 F. Supp. 368, 371 (D. Md. 1989).

972. J&R Ice Cream Corp. v. Cal. Smoothie Licensing Corp., 31 F3d 1259, 1266 (3d Cir. 1994).

973. Scarlata v. Siegel Bus. Serv., Inc., No. 88-02153 (Pa. D. & C. Chester, 1989).

974. Roberts v. Gen. Motors Corp., 643 A.2d 956 (N.H. 1994).

975. L.I.C. Corp. v. Baskin-Robbins Ice Cream Co., 1993 Tenn. App. LEXIS 4, at *10 (Tenn. Ct. App. 1993).

976. Meineke Disc. Muffler v. Jaynes, 999 F.2d 120, 125 (5th Cir. 1993) (upholding trial court's dismissal of claim for intangible property). *Cf.* Nelson v. Data Terminal Sys., Inc., 762 S.W.2d 744, 746-47 (Tex. App. San Antonio 1988) (giving rights to dealer that purchased goods from the manufacturer under the texas little FTC).

977. O'Brien v. Union Oil Co. of Cal., 699 F. Supp. 1562, 1570 (N.D. Ga. 1988) (holding that even if franchisee was a consumer, refusal to approve sale/transfer on part of franchisor did not constitute harm to the general consuming public).

978. Standing found in Clark v. America's Favorite Chicken Co., 916 F. Supp. 586 (E.D. La. 1996). But no standing in Popeye's, Inc. v. Tokita, 1993 WL 386260 (E.D. La. Sept. 21, 1993), or Delta Truck & Tractor, Inc. v. J.I. Case Co., 975 F.2d 1192, 1205 (5th Cir. 1992) (applying Louisiana law).

prophylactic influence of more effective watchdogs and sometimes defers to the regulated on violations within its mandate. FTC officials are quick to point out—and are correct in doing so—that Congress sets the FTC's mandate. Senators Cochran, Collins, and Grassley asked the General Accounting Office (GAO) to review the FTC's enforcement of existing law, and the GAO issued a report in July 2001.[979] Given that the FTC does not pursue Section 5 enforcement, to the extent that the GAO report dealt with FTC action the results were not surprising. Most troublesome, and most indicative of regulatory capture, is the FTC's assertions as to relationship issues not being a major problem in franchising.

At the outset of this paper, it was noted that the American Bar Association Section of Antitrust Law conflated regulation of the franchise *sale* with regulation of the franchise *relationship*. Attorney David Kaufmann, counsel to the National Franchise Council and major franchisors, proceeds in a similar vein in his Practice Commentary discussing the GAO Report:

> [T]he initial premise of the AFA and other franchisee activists seeking radical federal franchise legislation—that there are untold numbers of franchisees complaining of FTC Rule violations who are getting no response from the FTC itself—is utterly without merit . . . the GAO Report makes clear that the FTC did, in fact, respond in a meaningful fashion to all franchisee complaints it received over which it had *jurisdiction under the FTC Franchise Rule.*[980]

As with the ABA, the statement by Kaufmann erroneously links two distinct issues. In public comments to the FTC's Advance Notice (ANPR) and subsequent Notice of Proposed Rulemaking (NPR), many franchisees advocated that the Franchise Rule should be done away with since it did nothing but provide cover for franchisors and mislead franchisees into believing that the FTC was there "to protect you."[981] The complaint of the AFA and franchisees is that the FTC does not exercise jurisdiction over the *relationship*—which is a *Section 5* matter not a *Franchise Rule* matter. As Kaufmann is well aware, the Rule requires pre-sale disclosure. The point of the AFA is that since the FTC will only consider Rule violations and not Section 5 violations,

979. GAO 2001 Report, *supra* note 217. This is the second GAO report, the first being FEDERAL TRADE COMMISSION: ENFORCEMENT OF THE TRADE REGULATION RULE ON FRANCHISING, (July 13, 1993) *available at* www.gao.gov (last visited March 2003). The first GAO report will hereinafter be referred to as "GAO 1993 Report."

980. David J. Kaufmann, *2001 Supplementary Practice Commentary*, N.Y. GEN. BUS. L. §§ 680-695 (2001 & Supp. 2003).

981. *Franchising Relationship*, *supra* note 49, at 23 (statement of Susan Kezios, President, American Franchisee Assn.).

relationship legislation is necessary. Kaufmann then quotes the section of the GAO Report where the FTC staff says they feel that "franchise relationship problems are isolated incidents."

Perhaps Mr. Kaufmann and the FTC staff would do well to speak with franchisees who experience the reality of franchisor overreaching every day in scores of nations around the world. American franchisees know that it is pointless to complain to the FTC, and that is why they do not do so. According to an FTC Table of "Section 5 Complaint Allegations" from 1993-2000, the agency only received 10 complaints about "exclusive territories" (Ranked #6). By way of contrast, the same table notes 28 complaints about "Testimonials/References" (Ranked #2) and 94 about "Earnings" (Ranked #1).[982] Given the encroachment wars, it is difficult to imagine that in 7 years there were only 10 complaints about territory. Equally unlikely is that testimonials rank high on any franchisee's list of concerns. If one assumes that each of the 261 Section 5 complaints over the period of the study (data from 1993 through June 1999[983]) came from a different franchise, this equates to less than 1 complaint per week during one of the most contentious decades in franchise history. The FTC and franchisors draw the conclusion that the data is evidence of bucolic bliss in franchiseland. The FTC interpretation is flawed, but serves the political goals of the franchise industry. A more plausible explanation of the data is that franchisees know exactly what the FTC is concerned with—(1) earnings claims in the UFOC and (2) keeping the franchise industry happy.

Although the FTC is concerned with disclosure issues, the GAO report repeated the FTC's speculation as to relationship issues. Although the GAO added the caveat that there was a paucity of empirical data and a need for further study, this was quickly lost in the publicity blitz mounted in the wake of the report. The head of the National Franchise Council (NFC) (a militant offshoot of the IFA comprised of the largest franchisors) remarked that the FTC wasn't interested in doing a further study, and that if the SBA wanted to do a study it would have to get money from Congress. The NFC, which boasts of its "partnership" with government[984] was pleased with the GAO's inclusion of the FTC's relationship ruminations; the NFC president boasted "When I'm on [Capitol] Hill, I'll be carrying this around."[985]

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982. Bureau of Consumer Protection, Federal Trade Commission, *Section 5 Complaint Allegations*, *in* FRANCHISE & BUSINESS OPPORTUNITY PROGRAM REVIEW 1993-2000, 39 (2001).

983. *Id.* at 4.

984. *See Amicus Brief*, *available at* www.nationalfranchisecouncil.org/newsctr/briefs/gnc.htm (last visited March, 2003).

985. *GAO Report as Seen From Both Sides*, FRANCHISE TIMES, Sept. 2001, at 5, 6

The GAO report was the subject of much discussion within the franchise bar both prior to and subsequent to its release. Apart from the public relations value of the speculative portions of the report, is difficult to understand why so much controversy. A cursory review of the 17-volumes of cases in the CCH *Business Franchise Guide* will demonstrate that most franchise disputes would be covered, if at all, under Section 5. However, in the entire history of the FTC, the Commission has conducted a mere two investigations based solely on Section 5. Both investigations resulted in no action; the GAO noted, "for the FTC to find unfairness, there must still be substantial injury that is not outweighed by countervailing benefits."[986] Since franchise-specific Section 5 enforcement is an ancillary backwater of the Franchise Rule, and the Franchise Rule applies only during the pre-sale phase, it borders on tautology to say that any analysis of FTC activities would have little relevance to most franchisees, given that relationship issues (e.g., encroachment, termination/renewal, sourcing) are not governed by the Franchise Rule. One would expect to find the rare instance of legally inadequate disclosure, or outright fraud, but most franchisors have capable attorneys, and if they do not they can get a referral from the IFA to franchisor counsel. The FTC might pursue the bit players, but the major brands such as Dunkin' Donuts, Burger King, or Subway are not likely to run afoul of Franchise Rule technicalities.

And that is precisely what the GAO report found. During the 1993-2000 period, none of the six franchisors which were the subject of court action are household names:

Building Inspector of America:	80 investors affected
Coverall North America, Inc.	2591
Direct Distributors, Inc.	290
Gingiss International, Inc.	209
Hillary's Gourmet Ice Cream	Unknown
Jani-King International, Inc.	900[987]

Furthermore, all six actions commenced exclusively under the Franchise Rule involved earnings claims. All 14 franchise actions involving both Franchise Rule and Section 5 violations involved earnings claims.[988] The 54 "Business Opportunity" cases brought under the Franchise Rule all involved earnings claims.[989] The moral of the story is

(quoting Neil Simon, executive director of "Nat'l Franchise Association" [sic]).

986. GAO 2001 Report, *supra* note 217, at 43.

987. *Id.* at 55.

988. *Id.* at 59-60.

989. *Id.* at 55-57.

that if you want to avoid the FTC's wrath, simply refrain from making earnings claims.

D. SBFA

Franchise industry supporters often make the case that franchising is *sui generis*, and therefore franchisors should be exempt from laws that would apply to other industries.[990] Even where pre-sale disclosure laws are supposed to protect franchisees, franchisors need not fear government enforcement: a 1992 General Accounting Office (GAO) report found that the Federal Trade Commission acted on less than 6% of the complaints brought to the FTC about franchisor pre-sale violations of law.[991] Franchisors believe exemption from normal law applies to good faith as well: at a recent Congressional hearing, Congressman Jerrold Nadler (D-NY) asked the franchisor industry (IFA) representative (Adler):

> Every other business in this country operates under the UCC, has a duty of good faith. Why—in a myriad of different kinds of business arrangements, millions of different kinds of business arrangements—why are franchisors so different that they should not operate under some of the same laws that everybody else does?[992]

The following exchange ensued:

ADLER: But let me give you a practical matter, as it is not a normal contractual relationship. It is a partnership. I do not view—some will differ with this—franchisees as my customers. They are my partners. And it is—

NADLER: Yes, but partners operate under the UCC—

ADLER: [continuing] Like a family.

NADLER: [continuing] Under the UCC.

ADLER: What is that?

NADLER: Partners operate under the—partners are great until they have a split, and then they have a bitter litigation. [Laughter]. Partners also operate under the UCC and under the normal commercial laws and under a duty of good faith.

ADLER: Well, I guess I am saying the current contract laws really work. The percentage of franchisees in litigation I am guessing are less

990. Byron E. Fox & Henry C. Su, *Franchise Regulation—Solutions in Search of Problems*, 20 OKLA. CITY U.L. REV. 241, 246 n.15 (1995). *See also*, *infra* note 1140, (property law in Brazil) and *supra* note 742 (property law in France).

991. Testimony of Adler, *infra* note 993.

992. *Franchising Relationship*, *supra* note 49, at 85.

than a fraction of 1% right now. So the cases, if you peel them back, a lot of the cases—the reality is the FTC has only investigated 6%. I have no knowledge of that, but maybe the 94% didn't have substance behind them.[993]

Partners have fiduciary duties to one another,[994] but franchisors specifically object to provisions in the proposed SBFA imposing a fiduciary standard on franchisors.[995] Conversely, franchisors cloak themselves in the partnership mantle when speaking to prospective franchisees or opposing statutory oversight: franchising is "not a normal contractual relationship." Indeed, most franchisees would agree and cite this as a good reason for franchise-specific legislation. IFA' s franchisor members tell legislators and prospective franchisees that franchising is a partnership, but no IFA *amicus* brief has ever taken the position that franchising is a partnership, and one can search the Reporters in vain for a single case in which an IFA member told a judge that franchising is a partnership.

Congressman Nadler asks a simple question: Why can't franchisors live by the same laws as everyone else?[996] The IFA representative avoids a direct response, instead linking the concept of good faith with FTC oversight in a manner suggesting that since the FTC was is aggressively pursuing complaints against franchisors, there is no need for franchisors to comply with standards of good faith and fair dealing applicable to the rest of American business. In evaluating the franchisors' claim that they should be held to a lower standard than other industries, it should be remembered that "business" relationships already permit much greater latitude for abuse than "consumer" before courts will step in.[997] The IFA

993. *Id.* Michael Adler, President of franchisor Moto-Photo, spoke on behalf of the International Franchise Association.

994. Partners may reasonably limit fiduciary duties by agreement. *See* comments 5 and 6 to RUPA § 103, *supra* note 128; comments 2 and 3 to RUPA § 404, *supra* note 128.

995. A limited fiduciary duty was proposed in Section 5 of the SBFA. A complete text and discussion from a franchisee-side perspective is available at www.franchisee.org.

996. Note that unlike franchising, distributorship agreements are generally under the UCC, with courts applying the "predominant purpose" test and finding the entire agreement under the UCC, although a minority holds that only the goods portion of the agreement is under UCC and the services portion under common law. Watkins & Son Pet Supplies v. Iams Co., 254 F.3d 607 (6th Cir. 2001) (applying UCC but noting that where service component predominated, UCC not applicable); SMR Tech. Inc. v. Aircraft Parts Int'l Combs, Inc., 141 F. Supp. 2d 923 (W.D. Tenn. 2001) (applying minority view: UCC applied to goods part of transaction and common law to sale of services part); Continental Casing Corp. v. Siderca Corp., 38 S.W.3d 782 (Tex. App. 2001) (applying Texas law: UCC applies where essence of contract is sale of goods).

997. Compagnie de Reassurance D'Ille de France v. New England Reinsurance Corp., 825 F. Supp. 370, 381 (D.Mass. 1993) (under § 11 "the objectionable conduct must attain

representative also reiterates the canard that the franchisor relationship is not a business relationship, but rather a partnership between members of a family. Leaving aside for the moment the substantive merits of the IFA representative's claim, many franchisees find themselves in bitter litigation, where the procedure followed is not conducive to the franchisee receiving the fruits of the contract anticipated at the signing of the franchise agreement. A minority of franchisors do not oppose the SBFA's requirement for franchisor behavior in conformity to that followed in other industries, as the President of one franchisor noted: "I don't think franchising should be exempt from such duties. If you're an honest franchisor . . . then a law like [SBFA] won't affect you."[998] Indeed, the Canadian province of Ontario now provides for regulation of the franchise relationship with a law quite similar to the proposed SBFA,[999] and franchising has not met an untimely death in Ontario any more than auto franchising or gasoline franchising were killed by U.S. legislation regulating those franchises.

E. Beguiling Heresy: Equitable Principles of Good Faith & Unconscionability

There is a relationship between good faith and unconscionability, and some court decisions discussing good faith are more accurately concerned with principles of hardship or unconscionability.[1000] As with good faith, "the role of unconscionability is better described than defined."[1001] One court explained the doctrine:

> [A]s in other areas of equity-related doctrine, conduct which is "unconscionable" will commonly involve the use of or insistence upon legal entitlement to take advantage of another's special vulnerability or misadventure in a way that is unreasonable and oppressive to an extent that affronts ordinary minimum standards of fair dealing.[1002]

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a level of rascality that would raise an eyebrow of someone inured to the rough and tumble world of commerce").

998. Bruce J. Major, *Opinion: Two Points*, FRANCHISE TIMES, Feb. 2001, at 11. Major is President of Munchelinos and previously chief development officer for Sandella's. *Id.*

999. For a description of the legislation, *see* Philip F. Zeidman, *Just across the Border*, FRANCHISE TIMES, Jan. 2001, at 44.

1000. Pennington's Inc. v. Brown-Forman Corp., 785 F.Supp. 1412, 1415-16 (D. Mont. 1991).

1001. Austl. Competition & Consumer Comm'n v. CG Berbatis Holdings Pty Ltd., (2002) 169 A.L.R. 324 (citing Antonoviz v.Wolker (1986) 7 NSWLR 151, 165) [hereinafter *Berbatis*].

1002. *Id.*, citing Austl. v. Verwayen, (1990) 170 C.L.R. 394, 441.

In one episode of the Australian epic *Burger King Corp. v. Hungry Jack's Pty Ltd*, a disloyal franchisee employee actually working on behalf of Burger King tells Burger King to use a "carrot and stick" approach, the "stick" including "to get tough on sticking to the letter of the law on existing agreements with legal sanctions to follow."[1003] Given the range of franchisor discretion in operation of the franchise and modifications of the franchisees obligations, courts should look to equitable principles.

Courts and legislatures are wary of equity in the commercial setting, viewing the doctrines as a slippery slope toward contractual uncertainty. This is not an unfounded concern. In 1976, an Australian commission recommended against adopting the US Federal Trade Commission prohibition of "unfair" conduct because of the uncertainty that would be introduced onto commercial contracts, and the Australian 1986 Trade Practices Revision Act prohibited "unconscionability" in consumer transactions.[1004] Subsequently, a commission on small business recommended the Act be extended to small business transactions, but the Franchising Taskforce recommended against the Act's extension to franchise transactions.[1005] In 1991 the Act, while explicitly not extending the concept, codified the equitable remedy and by 1999 a judge applying the doctrines of good faith and unconscionability and upholding termination of a Subaru dealer under the Franchising Code ruled: "I take as the measure of unconscionability, conduct that might be described as unfair."[1006] Making matters more confusing is a Subway case in which the Canadian court equated unconscionability in franchising with the standard for undue influence in a donor-donee relationship.[1007]

In analyzing the implied covenant of good faith and fair dealing, the English experience is a useful guide. The integration of European commerce has led English legal scholars to attempt to reconcile the English common law system with the civil law systems of the continent. In so doing, English scholarship has looked to the conceptual and historical roots of the doctrine of good faith and has applied comparative law analysis. In contrast, American commentary on the doctrine of contractual good faith has focused on recent case law and avoided foreign comparative analysis:[1008] American courts generally decline to

1003. Burger King Corp. v. Hungry Jack's Pty Ltd., 1998 Aust Fedct Lexis 602, at **13-14. Note that this was one of many decisions in the multi-year litigation.

1004. *Berbatis,* 169 A.L.R. 324.

1005. *Id.*

1006. *Id.*, citing Garry Rogers Motors (Aust) Pty Ltd v. Subaru (Aust) Pty Ltd., 1999 Aust Fedct LEXIS 495, at *24..

1007. Ellis v. Subway Franchise Sys. Of Can., 2000 Ont. Sup. C.J. LEXIS 999, at **13-14.

1008. *See*, Ronald T. Coleman & Robert T. Joseph, *The Duty of Good Faith and Fair*

venture beyond domestic case law.[1009] Such a narrow focus fails to provide a complete picture of franchise law; particularly implied contractual terms in franchise agreements. Foreign legislatures are beginning to pass franchising laws in response to the global expansion of American franchisors;[1010] global commercial norms will become increasingly important to U.S. franchisors.

The degree to which good faith should be used to override the express terms of a contract is a matter that has divided the courts long before the advent of franchising. At one extreme is the *Union Eagle* case, in which a ten-minute delay was held contractual breach sufficient to warrant substantial forfeiture.[1011] While the court frames the issue in terms of unconscionability, the line between good faith/fair dealing and unconscionability is a thin one, as evidenced in the court's views on doing equity.

Quickly dismissing the arguments relating to specific performance, Lord Hoffman turned his attention to the draconian sanction of forfeiture due to a 10-minute delay. He observed that some of his peers believed the court's ability to do equity is "unlimited and unfettered."[1012] Hoffman noted that such a position is "beguiling heresy":[1013]

> It is worth pausing to notice why it continues to beguile and why it is a heresy. It has the obvious merit of allowing the court to impose what it considers to be a fair solution in the individual case. The principle that equity will restrain the enforcement of legal rights when it would be unconscionable to insist upon them has an attractive breadth. But the reasons why the courts have rejected such generalizations are founded not merely upon authority [citation] but also upon practical considerations of business . . . *it is of great importance that if something happens for which the contract has made express provision, the parties should know with certainty that the terms of the contract will be enforced.* The existence of an

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Dealing: What Standards Apply, *in* FRANCHISING: THE NEXT GENERATION (1997); DeWitte Thompson, *Good Faith and Fair Dealing: A Contract is a Contract is a Tort*, *in* BEYOND THE FOUR CORNERS: IMPLIED TERMS, LIABILITIES, AND DEFENSES IN CONSTRUCTION CONTRACTING (2001). Construction contract litigation frequently involves implied obligations. *See* Stanley Sklar et al., *Implied Duties of Contractors: Wait a Minute, Where Is That In My Contract*, CONSTRUCTION LAWYER, Summer 2001, at 11.

1009. *See generally* William H. Manz, *The Citation Practices of the New York Court of Appeals 1850-1993*, 43 BUFF. L. REV. 121, 156-57, tbl. 11, 13 (1995) (most citations in court opinions are of local cases within the few years preceding the decision).

1010. BUSINESS FRANCHISE GUIDE, *supra* note 673, at ¶¶ 7000, 7300.

1011. Union Eagle Ltd. v. Golden Achievement Ltd., 2 All E.R. 215 (P.C. 1997).

1012. *Id.*, citing Shiloh Spinners Ltd. v. Harding, 1All E.R. 90, 104 (P.C. 1973).

1013. *Id.*, citing Scandinavian Trading Tanker Co. AB v. Flota Petrolera Ecuatoriana, 2 A.C. 694, 700 (P.C. 1983).

> undefined discretion to refuse to enforce the contract on the ground that this would be "unconscionable" is sufficient to create uncertainty . . . its mere existence enables litigation to be employed as a negotiating tactic. *The realities of commercial life are that this may cause injustice* which cannot be fully compensated by the ultimate decision in the case.[1014]

This begs the question as to *why* it is important that the parties know that the contract will be enforced, and whether the inherently uncertain and unilateral nature of a relational franchise contract leads us to a different result than *Union Eagle*. Enforcement of contracts as written provides economic certainty. In turn, economic growth is fostered which enriches the community and provides material comfort and social stability through the expansion of the economic base. It is conceded that movement towards a more flexible system which views "mom and pop" franchisees as akin to consumers does increase uncertainty for franchisors.[1015] Economics does not provide us with an end in itself, but rather a means to an end; enforcement of contracts is a social good:

> [I]nsistence on a good faith requirement in discretionary conduct in contractual formation, performance, and enforcement is only the fulfillment of the obligation of the courts to do justice in the resolution of disputes between contending parties.[1016]

Individual parties seek to maximize individual utility through a multitude of contractual relationships, and theoretically this will result in a Pareto-optimal outcome which would be destroyed by judicial intervention in the contractual obligations of the parties. Pareto-optimal outcomes are unlikely where one party can alter the terms of the contract *ex post*: an economically rational actor focused on maximization of profit will be unconstrained by the economically rational actions of the other party. This is the essence of Professor Hadfield's findings and the rationale underlying *Kodak*. A response heard by the authors is that the unfettered discretion and opportunism is known to potential franchisees when entering into contract; one franchise lawyer noted that he wouldn't sign his client's onerous contract but if someone else did they would have to live with the consequences. This is the franchisor corollary to

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1014. *Id.* 218-19 (emphasis added). In closing, Hoffman fires a parting shot at those who would call the verdict unfair, noting that the seller had had been unable to sell the property for five years, pending the outcome of the litigation *Id.* 222.

1015. Similar criticism has been leveled at the Restatement (Third) of Torts. W. Kennedy Simpson, et al., *Recent Developments in Products, General Liability, and Consumer Law*, 38 TORT TRIAL & INS. PRAC. L.J., 625, 650 (2003).

1016. Gateway Realty Ltd. v. Arton Holdings Ltd., [1991] 106 N.S.R.2d 180, 192. Note that the court took notice of "the unique interdependent nature" of the subject matter; analogous to a franchise relationship. *Id.* at 211

Andrew Selden's "power franchising" and is best described as "sadomasochistic franchising."

American franchisors should take note that although the classic English position has been opposed to good faith, the external social climate has influenced the legislative and judicial climate.[1017] As Britain integrates into the European Union, the issue of "fairness" will play a greater role in contracts—especially consumer contracts[1018]—a result of both EU legislation and increased trade with nations whose legal systems take statutory cognizance of fairness.[1019] Currently, European franchisees are presumed to be commercial entities.[1020] This is in spite of sale of franchises to individuals with little or no experience: the British Franchise Exhibition is touted as having "something for everyone no matter what the interest, previous experience, or budget may be."[1021] The reality is that many small franchisees are consumers, and Hoffman's rationale is less persuasive in the consumer context, particularly in contracts of adhesion. Often the consumer does not read, let alone understand, the contractual terms, and judicial or arbitral enforcement in the event of breach is—for the franchisee—cumbersome and not cost-effective. Moreover, when dealing with franchise agreements, it must be noted that such contracts are relationship contracts and hence, inherently uncertain. To the extent that franchisee duties are specific and can be altered at the sole discretion of the franchisor,[1022] while franchisor duties are limited, Hoffman's rationale becomes tenuous at best: the franchisee does not truly know the "terms of the contract."

Interfoto v. Stiletto[1023] is the clearest exposition of the difference between the British and the Continental systems, and suggests a possible solution to some American franchise disputes. Stiletto ordered transparencies from Interfoto, which Interfoto delivered, along with a note stating that transparencies not returned by a certain date would be charged to Stiletto at a rate of £ 5 per day. When Stiletto returned the transparencies late, Interfoto billed Stiletto. Ultimately, the court

1017. P.S. Atiyah, *Contract and Fair Exchange*, 35 U. TORONTO L.J. 1, 4 (1985). Atiyah was speaking specifically about British popular sentiment, but noted general applicability to Western societies. *Id.*

1018. Council Directive 93/13/EEC, 1993 O.J. (L095) 29.

1019. *See*, CODICE CIVIL, art.1175 (Oceana Publishers ed., 1991) ("The debtor and creditor shall behave according to rules of fairness.").

1020. Case 269/95, Benincasa v. Dentalkit Srl, 1997 E.C.R. I-3767, 135 para 31 (citations omitted).

1021. Bill Cadger, *Venture into Your Business Future*, HERALD (Glasgow, Scotland), June 21, 2001, at 29.

1022. By means of changes in the Operations Manual, selective enforcement of system standards, franchisor exercise of discretion, etc.

1023. Interfoto Picture Library Ltd. v. Stiletto Visual Programmes Ltd., 1 All E.R. 348 (P.C. 1988).

allowed only one-tenth of the damages sought[1024] and stated that since the onerous provision had not been fairly and reasonably brought to the attention of Stiletto, the provision was not part of the contract and Interfoto was limited to *quantum meruit*. The opinion of Justice Bingham is the more interesting because Bingham goes out of his way to disclaim any intent to be "fair" to Stiletto, focusing instead on the actions of Interfoto. In language suggestive of *Burger King v. Scheck* Bingham suggests that better drafting (i.e., notice that is more prominent) would have permitted egregious behavior: "The defendants are not to be relieved of . . . liability because they did not read the condition . . . they are to be relieved because the plaintiffs did not do what was necessary to draw this unreasonable and extortionate clause to their attention."[1025]

Bingham is aware that this is not the European view, and his discussion begins with a comparison of attitudes toward good faith in general and proceeds to an analysis of the application to onerous contract terms:

> [*I*]*n most legal systems outside the common law world*, the law of obligations recognizes and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other . . . its effect is perhaps most aptly conveyed . . . as "playing fair," "coming clean" or "putting one's cards face upwards on the table." *It is in essence a principle of fair and open dealing* . . . .[1026]

> English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness . . . .[1027]

> [c]ases on sufficiency of notice . . . are concerned with a question of pure contractual analysis, whether one party has done enough to give the other notice of the incorporation of a term in the contract. At another level they are concerned . . . *whether it would in all the circumstances be fair (or reasonable) to hold a party bound by any conditions or by a particular condition of an unusual and stringent nature.*[1028]

At very least, the degree to which a condition is burdensome to the other party should be a consideration in the prominence that condition is

1024. *Id.* (£ 3.50 per transparency per week, instead of £ 5.00 per transparency per day).
1025. *Id.* at 356.
1026. *Id.* at 352.
1027. *Id.* at 353.
1028. *Id.* (emphasis added).

given in the written agreement. The English approach of addressing unfairness through the application of an appropriate remedy is also one which provides flexibility lacking under the (American) FTC Franchise Rule. Finally, Bingham raises an equitable principle that has begun to find support in recent American research into Behavioral Decision Theory: targeting prospective franchisees and inducing false expectations of trust or partnership should be a factor in judicial or arbitral review.

F. Cognitive Process and The Disclosure Document: Proposal for Change

Much of today's legal scholarship is based on legal philosophies that ignore human nature and human history. Good franchise salesmen assess the motivations and vulnerabilities of their prospects, and franchisors base their sales pitches on knowledge of human behavior, not the rarified legal arguments presented by their counsel. A British franchise salesman cites Jesus Christ in an effort to get prospective purchasers to trust them,[1029] and in the United States the CEO of Mail Boxes Etc. tells franchisees that franchising's appeal "lies at the heart of the American Dream"[1030] and also states: "I believe that God authors dreams . . . . From that comes a collective power . . . you can see it throughout the world of franchising."[1031] Franchisors may "leave [morality] at the door,"[1032] ask "when do we **** [the franchisee],"[1033] place encroaching stores "every place we ****ing can,"[1034] punish franchisees who terminate adulterous affairs,[1035] "screw every one of [their franchisees],"[1036] celebrate in court the supremacy of the integration clause and franchisors' "shrewd" business tactics[1037]—but when it comes to public relations, franchisors speak of God, Jesus, and the American Dream.

The Chicago School may scoff at behavioral theory, but a number of attorneys are finding that Behavioral Decision Theory (BDT) can explain seemingly irrational contractual behavior, and distinguish

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1029. *ChemDry*, *supra* note 122. The authors have been unable to locate any contemporary record of Christ's views on the franchise industry.

1030. *Franchising Veteran Jim Amos Prepares to Take the International Franchise Association Helm*, FRANCHISING WORLD, Jan.-Feb. 2001, at 8, 10.

1031. James H. Amos Jr., *IFA & the Power of the Dream*, FRANCHISING WORLD, Apr. 2001 at 8.

1032. *Behar*, *supra* note 46.

1033. *See id.*

1034. *Behar*, *supra* note 46, at 130.

1035. *See Vylene Enterprises*, 105 B.R. at 45-46.

1036. *Winslow*, *supra* note 9.

1037. *See infra* Part IV, section f.

between improper manipulation, fraud, and false advertising.[1038] While fraud and false advertising have long been recognized by the courts, improper manipulation can be just as harmful, and should be recognized by the courts:

> Sales techniques are sometimes knowingly designed to create the impression that a relationship of trust exists, when, of course, it really doesn't, and that this in turn triggers known biases such as the cooperation bias, cognitive dissonance and the overconfidence bias, which collectively cause the decision maker to underestimate risk, to his or her detriment. Certainly people are responsible for the decisions they make. But where it can be shown that, because of an intentional manipulation of the ability to evaluate the circumstances clearly, the decision maker has made an awful mistake, there is room for an exception . . . especially in the non-regulatory environment.[1039]

Adaptive behaviors and societal norms remain integral to human decision-making long after they have ceased to confer evolutionary advantage: they remain even when they are a *disadvantage*, a phenomenon known as "time-shifted rationality."[1040] Even in the Internet Age, trust conveys economic benefits,[1041] and trust was even more critical to survival for most of human existence. At one time, in the small settlements and villages where humans first settled, cooperative behavior favored both individual and community, whose fates were closely intertwined.[1042] When a franchisee deals with "the franchisor," the franchisee is most often dealing with a local agent of the franchisor corporation, who may not even be an employee of the corporate entity but rather a local independent franchisee with the rights to develop a particular territory.[1043] Franchisors have spent considerable time and expense to be seen as part of the local community, and the local agent is the "face" of the franchisor corporation. The franchisee perceives that the franchisor is part of the same community, and the evolutionary bias towards cooperation and integrity affects contractual behavior in a manner irrational for modern franchising. For millennia, Professor

1038. Paul Bennett Marrow, *Behavioral Decision Theory Can Offer New Dimension To Legal Analysis of Motivations*, N.Y. ST. B.J., July-August 2002, at 46-48.

1039. *Id.* at 48.

1040. Owen D. Jones, *On the Nature of Norms: Biology, Morality, and the Disruption of Order*, 98 MICH. L. REV. 2072 (2000). *Cf*, WILSON, *supra* note 713, at 106 ("Myth and self-deception, tribal identity and ritual, more than objective truth, gave . . . adaptive edge.").

1041. *Web of trust*, ECONOMIST TECH. Q. , Sept. 21, 2002, at 10 (degree of trust among citizens of given country accounts for two-thirds of differences in national usage of Internet; trust is culturally and historically based and influences marketplace behavior).

1042. WILSON, *supra* note 713, at 183 (kin selection as epigenetic rule).

1043. For example, the Subway sandwich chain franchises in this manner.

Posner's analysis of contractual behavior was true, and it remains true for most *franchisee* behavior. However, in a complex society where parties to a contract do not have the personal interaction of a pre-modern age, societal norms are less effective. We have instead moved to an era of human interaction thru litigation: franchisors do not bother to defend their ethics but rather state that it is the fault of the franchisees that they failed to read the fine print of the franchise agreement, UFOC, and Operations Manual. Form is valued over substance; historically respected social norms fall by the wayside and lawyers ponder what the meaning of "is" is. Integrity and cooperation are quaint throwbacks to a bygone era, and ADR proponents try to persuade clients that mediation is not a sign of weakness. Even then, franchisors have turned tools of conciliation into offensive weapons: arbitration as a means of avoiding the consequences of opportunistic behavior and effecting the bankruptcy of hapless franchisees.

If one holds a conception of the law as more than merely a branch of economics, game theory has its limits: this is particularly true where informational disparities lead to seemingly irrational behavior on the part of prospective franchisees. Even absent informational disparities, reputational damage may not affect all segments of the prospective market for franchisors, and therefore lack prophylactic effect: Professor Warren Grimes alleges that the Subway franchise may have suffered reputational damage as part of a calculated strategy to grow short-term royalties at the expense of long-term reputation.[1044] If true, the strategy worked well for the franchisor and poorly for the franchisees. As one attorney noted of his Subway franchisee clients: "The fact is these people were in business for just 18 months and they lost their shirts."[1045] The market failure seen in the franchise sales industry is one which must be addressed legislatively due to judicial reluctance to apply the implied covenant of good faith and fair dealing in franchise contracts. The judicial reluctance has some basis, but legislators should not shy away from preventing franchisor overreaching for fear of the economic clout of the franchise industry.

Franchise regulation must take into account the psychology of franchise sales. Currently, franchising is regulated primarily by means of pre-contractual disclosure. Few states (Iowa is a notable exception) regulate the actual franchise relationship, despite the fact that a franchise relationship is more than the written agreement of two parties. As an ongoing relationship of mutual benefits and obligations, there is a

1044. LAW OF ANTITRUST, *supra* note 258, at § 8.2 and n.45 (citing Marsh, *Franchise Realities*, WALL ST. J., Sept. 16, 1992, at A1.)
1045. Dwyer, *supra* note 70.

reasonable expectation of contractual solidarity by the franchisee. It is an expectation explicitly encouraged by the franchisor from the outset of the relationship: the franchisee is in business "for yourself, but not by yourself." The franchisor projects a pre-sale image of atomistic entrepreneurship, but the post-sale reality is at best a benign dictatorship: franchisees are no more "partners" than the "partners" who make your espresso at Starbucks each morning.

The "partnership" misrepresentation by the franchisors is highly effective and greatly complicates any attempt at statutory regulation of the relationship. This is particularly true when the regulation consists of pre-contractual statutes affecting only the "courtship" phase and not the post-contractual "partnership." If the franchisee believes that the "partner" is true and faithful, the franchisee will overlook flaws obvious to the impartial observer. A 7-Eleven franchisee of 14 years explained:

> The pre-sale process is a "honeymoon" period when the franchisor is simply wooing a prospective bank account and the potential Franchisee is hoping against hope that her or she will be "qualified" or "accepted" to become part of the franchise system. When you are on the threshold of living the American dream of owning your own business, and the party with greater power holds the keys that unlock that door, all you want is to be "accepted." Generally, you don't ask the hard questions because you don't want to be perceived as a "problem" before you even get the keys.[1046]

A frequent flaw is the difference between what the franchisor says and what the franchisor puts in writing:

> The only protection that a franchisee could have in those circumstances would be to require that the standard form contract be amended to reflect the representations prior to signing it. However, this hypothesis ignores general business practicalities. Firstly, it assumes a relative strength of bargaining position between franchisor and franchisee which is not usual. Secondly, it ignores the natural conclusion of the franchisor that this perspective [sic] franchisee is a "troublemaker" and should therefore be avoided in the first place or if taken on, should receive "special attention" and be a prime candidate for replacement by someone more malleable.[1047]

The 7-Eleven franchisee identifies a key reason why even the additional disclosures proposed by the FTC (and opposed by franchisors) would be insufficient to prevent post-contractual abuse at the hands of

1046. Letter from Teresa Maloney, National Coalition of Associations of 7-Eleven Franchisees, to Secretary, Federal Trade Commission. (April 27, 1997) *available at* http://www.ftc.govv/bcp/franchise/comments/final38.htm (last visited March 2003).

1047. Head v. Inter Tan Canada Ltd., 1991 Ont. C.J. LEXIS 513, at *45.

franchisors. Most people do not enter into a "partnership" assuming the worst. Just as a prospective bride or groom might balk if their betrothed proposed an airtight prenuptial contract, so too might a franchisor have legitimate concerns about a prospect who was focusing on the "hard questions" since it is indicative of a "problem" franchisee. This is not unique to franchising, but is a commonsense concern of any party contemplating a relational contract. This author worked in the retail sector on Wall Street. When a new client opens an account it is common practice to verify with a compliance data service whether the client has had any "problems" in the past. Many times there is an innocent explanation of any "problem," but there are stockbrokers and brokerage firms that will not do business with such a client and the client will not be told the reason. Faced with a prospect that focuses on the minutiae of a UFOC, a franchisor may wisely decide not to do business with the prospect. The franchise agreement is a long-term relational contract whose success depends on ambiguity and discretionary latitude sufficient to respond to a changing market. In short, it is based on trust. Relational contracts bear a remarkable similarity to social relationships, and the response of the 7-Eleven franchisee would not surprise a sociologist:

> Trust implies expectations that have an open-ended character. When we trust a friend, we do not have a list of all the things she is supposed to do; we trust her to do what is fitting and appropriate to the circumstances and to our relationship, as situations change and needs arise . . . . There are no guarantees, and it would be an indication of lack of trust to look for them.[1048]

The cooperative qualities that serve a franchisee well in daily life are the opposite of the adversarial qualities that would keep them from buying a pig-in-the-poke[1049] UFOC, something frequently overlooked by franchise attorneys analyzing franchisee behavior *ex post*.

The potemkin village of the franchisor does not need streets paved with gold; the truly successful franchisor taps a deeper—non-monetary—desire. As Professor Macneil noted: "organic solidarity is pinned on psychology—not on sociology, economics, law, politics, or force, but psychology."[1050] Franchisors hold out the illusion of organic solidarity

1048. TRUDY GOVIER, SOCIAL TRUST AND HUMAN COMMUNITIES 4 (1997).

1049. The expression is as old as Chaucer (1386), and refers to not looking in the "poke" (sack) before buying the pig; buying something of unknown value. Given that most franchisors will not put earnings claims in writing, (UFOC Item 19) and reserve significant and unilateral discretionary power post-contract, most franchisees have no way of determining the true value of the franchise *ex ante*. *See generally* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124-30 (1974).

1050. IAN R. MACNEIL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN

only to deliver the reality of an integration clause in a contract of adhesion, and contracts of adhesion *are* pinned on law, politics, and force.

Franchisors would maintain that society is comprised of sophisticated and economically rational actors, but this is not true for individuals,[1051] groups of individuals such as juries,[1052] or corporations.[1053] To the extent that franchisors target less-sophisticated prospects, economically irrational behavior by prospects may be greater;[1054] sunk costs such as found in franchising are one factor skewing rational decision making.[1055] Franchise agreements entered into by such prospects is particularly susceptible to constraints of bounded rationality.[1056] If economic decision making is often irrational, "dogmatic antipaternalism" exhibited by franchise regulators and courts may be unwise.[1057] This is not to deny any influence of economic reasoning, but rather to point out that there is at least as much emotion as economics in the franchise purchase. Even if prospective franchisees were economically sophisticated actors, risk assessment involves assigning probability and magnitude values to the universe of potential outcomes.[1058] Assignment of probability values based on turnover ratio

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CONTRACTUAL RELATIONS 92 (1980).

1051. Jack Lucentini, *A Game of Cash And Carry and a Grudge*, NEWSDAY, July 9, 2002, at D1 (experiment showing roles of envy and fairness resulting in economically detrimental decision-making); Roger Lowenstein, *Exuberance Is Rational*, N.Y. TIMES MAG., Feb. 11, 2001, at 68 (findings of economist Richard Thaler). *See also* Eyal Zamir, *The inverted Hierarchy of Contract Interpretation & Supplementation*, 97 COLUM. L. REV. 1710, 1793-95 (limited human cognitive capacity). *See also* discussion of "bounded rationality," *infra* note 1056.

1052. W. Kip Viscusi, *Corporate Risk Analysis: A Reckless Act*, 52 STAN. L. REV. 547, 586 (2000) (mock jury response to cost-benefit analysis performed by defendant is increased likelihood of punitive award to plaintiff).

1053. Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 625 (1989) ("Winner's Curse").

1054. WILSON, *supra* note 713, at 226-227 (inborn heuristics more influential among less educated). *Cf.*, Alan B. Krueger, *Economic Scene*, N.Y. TIMES, May 24, 2001, at C2 (actual discount rate 7% for Pentagon buyout plan. Servicemembers average valuation exceeded 25%, highest among: enlisted, less educated, young, and minorities).

1055. Roger Lowenstein, *Exuberance Is Rational*, N.Y. TIMES MAG., Feb. 11, 2001, at 68, 70.

1056. Bounded rationality is the concept that finite capacity to process information limits applicability of theory of the economically rational actor. *See* JOHN BLACK, OXFORD DICTIONARY OF ECONOMICS 36-7 (1997). *See also generally*, Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995).

1057. *Cf.*, Roger Lowenstein, *Exuberance Is Rational*, N.Y. TIMES MAG., Feb. 11, 2001, at 68, 70 (Cass Sunstein observation on implications of Richard Thaler's findings on privatization of Social Security).

1058. *Cf.* William K. Lescher, *Missile Defense Is for the Real World, in* U.S. Naval Institute, *Proceedings*, July 2001, at 50 (noting that further analysis necessary in cases

will lead to an underassessment of risk by the prospective franchisee: sunk costs and the difficulties—practical and psychological—of addressing failure and returning to the traditional workforce lead to franchisees remaining in marginal franchises. This leads to lower turnover than in an analogous environment in the traditional workplace that is the frame of reference for prospective franchisees contemplating the move from employee to franchisee.

The regional agent of a major franchisor once told the authors that franchisees complained to franchisor headquarters that the regional agent ignored the franchisees and did not support the franchisees after the franchise was opened for business. Leaving aside the merits of the regional agent's complaint, the attitude of both parties involved illustrates the nature of the difficulty in finding a legislative or judicial solution. The franchise relationship is not a discrete transaction in an efficient market; rather, it is an ongoing relationship commenced under conditions of informational and economic disparity between the parties and continued under conditions of economic and psychological dependence by the franchisee upon the franchisor. The disparities are exacerbated by a legal paradigm favoring clever drafting and onerous venue and forum provisions disadvantageous to the weaker contracting party. To the extent that the psychological aspect of the franchise sales process is dealt with in the legislative and judicial processes,[1059] any solution will have to be sufficiently dramatic as to overcome the cognitive dissonance[1060] of prospective franchisees.

G. Red Hand of Disclosure

Data volume is not as important as the manner of data presentation, and the disclosure process—not simply the UFOC—needs to reflect that common-sense reality. Starting with the UFOC itself, conditions that are

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where probability is low but magnitude high). The significance for franchisees is that assuming, *arguendo*, franchisor statistics of probability, it is virtually impossible to assess magnitude of loss less than total investment; therefore making it impossible to assess expected monetary value of decision to purchase franchise. Further, the franchisee may lose more than the cash investment if loans are collateralized, if the franchisor seeks present value of projected royalties under the term of the original franchise agreement, or if the franchisee dips into a trust fund or other tax accounts for operating expenses.

1059. This paper does *not* advocate application of psychological principles to override statutes or case law. There are both moral and economic bases for bringing a balance to the franchise relationship, and an understanding of the motivation for and psychology of selling is a tool to draft legislation that would promote an efficient market in franchise sales. Inquiry into the morals—or lack thereof—possessed by franchisors is not a precondition to advocacy of such legislation. However, to the extent that the resultant legislation embodies and shapes moral values, this would appear to be more in accord with the general public's conception of the law than Justice Holmes' "bad man" theory.

1060. *See* LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE (1962).

onerous or unusual should be highlighted in a manner sufficient to appraise the prospect that the conditions warrant attention. The degree to which the condition needs to be highlighted would depend on the circumstances, as one court explained:

> [t]he more unreasonable a clause is, the greater the notice which must be given of it. Some clauses which I have seen would need to be printed in red ink on the face of the document with a red hand pointing to it before the notice could be held to be sufficient.[1061]

Since franchise agreements are contracts of adhesion, it is not unreasonable to require the franchisor to disclose on the front cover and in large type pertinent data. Prominently printed in red should be a notice[1062] to the franchisee of onerous terms, including an explanation of the rights waived by the arbitration clause,[1063] the cost of arbitrating in a distant forum, and the subjective nature of franchisor actions (such as compliance reviews and site selection) which can effectively bankrupt the franchisee. Any requirement must be by Congressional legislation: when Montana required that the arbitration clause be "typed in underlined capital letters on the first page of the contract"[1064] the U.S. Supreme Court said this was invalid as preempted by the Federal Arbitration Act.[1065]

Current FTC regulations[1066] require a cover sheet with an FTC

1061. J. Spurling, Ltd. v. Bradshaw, 2 All E.R. 121, 125 (P.C. 1956).

1062. In the securities industry, "red herring" refers to the offering circular for a new issue of stock to the public. The circular is submitted for comment and revision to the Securities and Exchange Commission (SEC) in Washington, D.C. After the SEC reviews the circular, the circular requires revisions—often, several series of revisions—before it can be shown to the public. The circular is also available at SEC reading rooms around the country and on the Internet. In addition, most states have "blue sky" laws, which make further demands on the securities issuer before money is taken from any resident of the state. In short, an individual investing $100 in a stock is afforded more governmental oversight and informational transparency than an individual investing $100,000 in a franchise. The prophylactic effect of SEC "post-sale" enforcement is in marked contrast to the Federal Trade Commission post-sale franchise regulation, which encourages opportunistic franchisor behavior.

1063. *Cf.*, Milnes v. Salomon, Smith Barney, Inc., N.Y.L.J., Nov. 22, 2002 at 29 (The account application stated that the applicant had received notice of arbitration clause: "clause itself . . . buried in the fine print on page 3 of the Client Agreement." However, there was no proof that the agreement was received, "or that it was called to [the applicant's] attention and explained . . . so that there was a meeting of the minds.").

1064. MONT. CODE ANN. § 27-5-114(4) (1995).

1065. Doctor's Associates Inc. v. Casarotto, 517 U.S. 681 (1996). *But see* Brinson v. Martin, 469 S.E.2d 537 (Ga. App. Ct. 1996) (upholding forum selection clause in part because of the prominence and typeface of the provision).

1066. Federal Trade Commission Franchise Rule, 16 C.F.R. § 436.1 (2000). FTC Rules and Advisory Opinions are generally *available at* http://www.ftc.gov/bcp/menu-fran.htm.

disclaimer in 12-point boldface type.[1067] However, the substance of the disclaimer is that the FTC does not know if any of the information in the UFOC is correct and that the prospect should read the contract. Although American courts may be reluctant to draw distinctions between bargained-for contracts and contracts of adhesion, not all legal systems agree. In 1942, Italy was the first European nation[1068] to recognize that the *contratto d'adesione* was different, and *Codice Civil* Article 1341 provides that the terms are only effective if the other party knew or should have known of the terms, using ordinary diligence. Even with that protection, commentators have urged that 1341 be strengthened, with judges reviewing all adhesive provisions and rejecting those provisions that were not "fair and reasonable."[1069]

Franchise agreements should impose an ongoing duty of disclosure with respect to changes which would affect franchisees under "agree to agree" clauses. If franchisor organizations such as the IFA and regulators such as the FTC truly believe in a disclosure regime, they should not oppose a letter going out each time such a modification is first introduced into new franchise agreements. For example, if a franchisor is going to raise advertising fees by 1% in a franchise where net profits average 3% to 5%, this is information which the franchisees should know immediately. Current franchisees should be given notice of this fact not later than the issuance of the first franchise agreement in which the clause appears, together with a franchisor estimate as to when the increase will take effect, or sufficient sales and turnover data to allow the franchisee to estimate the effective date of increase.

The small businessman is a fixture of American folklore and history. Benjamin Franklin owned a printing press and said that the promise of America was that anyone could succeed through initiative,[1070] and the man whose name became synonymous with the entrepreneurial spirit—Horatio Alger—sold a staggering 20 million-plus books between 1868 and his death in 1899.[1071] IFA founder Rosenberg proclaimed: "Franchising supports the great American dream of allowing multitudes

1067. 16 C.F.R. § 436.1(a)(21) (2004).

1068. Paolisa Nebbia, *Unfair Terms in Consumer Contracts: An Anglo-Italian Comparison*, *in* THE HARMONISATION OF EUROPEAN PRIVATE LAW 179, 182 (Mark van Hoecke & François Ost eds., 2000).

1069. GIOVANNI CRISCUOLI & DAVID PUGSLEY, ITALIAN LAW OF CONTRACT 32-33 (1991).

1070. BENJAMIN FRANKLIN, THE AUTOBIOGRAPHY OF BENJAMIN FRANKLIN AND SELECTIONS FROM HIS OTHER WRITINGS 222 (Modern Library ed., 1944).

1071. The first and most famous being HORATIO ALGER, RAGGED DICK; OR, STREET LIFE IN NEW YORK WITH THE BOOTBLACKS (Library Resources, Library of American Civilization 1970) (1868). *See generally* GARY SCHARNHORST WITH JACK BALES, THE LOST LIFE OF HORATIO ALGER, JR. (1985).

to own and succeed in their own businesses."[1072] Former Kentucky Governor John Y. Brown, who bought franchisor Kentucky Fried Chicken from Colonel Sanders, proclaims: "Franchising is more risky today, but it's still the great American dream."[1073] Franchisor advertising taps this powerful myth, as does the popular press. The New York State Attorney General's Office perpetuates the imagery:

> It's one of the most successful business techniques for people who want to get into [sic] the American dream. Franchising gives them the ability to do that. In New York State, we have so many people who are energetic, want to get involved in a legitimate business, and a legitimate franchise is a fabulous opportunity for those people and for the state as a whole.[1074]

Particularly in the case of immigrant franchisees, appeals to mythic images of the American dream may be more persuasive than a thick UFOC. The result is a franchisee perception of the environment at variance with reality. When reality intrudes in the form of a lengthy disclosure document in small typeface and legal language, dissonance produces a tension, which the prospective franchisee seeks to lessen.

Litigation and Sourcing Requirements are the two most obvious examples of this phenomenon. For example, the Subway sandwich chain was involved in a rash of litigation during the 1980s and '90s. Not all litigation need be disclosed in the UFOC, but the litigation that is disclosed in a recent Subway UFOC runs for 148 paragraphs (some paragraphs citing multiple cases), plus four state government actions. The list runs 28 densely packed pages, and only includes cases where the franchisor was a defendant.

Even less likely to be noticed by an unsophisticated purchaser is a requirement for sole-sourcing, particularly where the requirement is not currently in effect but is reserved to the discretion of the franchisor. Sole-source vendors imposed by franchisors mean that franchisees are at the mercy of the franchisor[1075]: *Queen City Pizza Inc. v. Domino's Pizza Inc.*[1076] alleged that franchisees were forced to pay 40% over market price for the pizza dough essential to operating a pizza franchise. A

1072. *Dunkin' Donuts, IFA Pioneer Rosenberg Leaves Legacy of Passion and Innovation*, NATION'S RESTAURANT NEWS, Oct. 7, 2002, at 23, 54.

1073. *Bullish on Franchising*, NATION'S RESTAURANT NEWS, Apr. 1, 2002, at 44.

1074. Kaufmann, *supra* note 22 (quoting Eric Dinallo of the New York State Attorney General's Office).

1075. *See generally*, Symposium, *The Law of Vertical Restraints in Franchise Cases & Summary Adjudication: Market Power in Franchise Cases in the Wake of Kodak, Applying Post-Contract Hold-Up Analysis*, 67 ANTITRUST L.J. 283 (1999) (debate between Warren Grimes and Benjamin Klein).

1076. 124 F.3d 430, 434 (3d Cir. 1997).

more cooperative approach was taken by the Subway franchisor in the 1990s, when it established an independent purchasing cooperative, which in the first five years of operation saved $107 million for franchisees.[1077] Franchisors have a legal "duty to make sure that the good or service really is of consistent quality"[1078] in order to keep the rights to their mark, but the 20,000 unit Subway chain has found a way to manage this in a manner which ensures the maximum benefit to its franchisees.

H. FTC Disclosure: Shield for Franchisors

The existing disclosure document is not only inadequate, it is counterproductive to the ostensible goal of disclosure. The UFOC and all other documents provided to the prospective franchisee need to be viewed in the light of an unsophisticated consumer entering into a contract of adhesion under conditions of huge informational and bargaining disparities.

Information disclosure may be used in perverse ways. First, by means of "information overload"[1079]—the likelihood of a legal document being read in its entirety by a franchisee is inversely proportional to the length and complexity of the document: Imagine *War and Peace* written by a lawyer, and one gets a sense of what a UFOC is like.[1080] Additionally, the volume of information may be used to "bury" damaging information, which would stand out in a shorter document. Prominence of a clause is not generally an issue in determining validity: small typeface occupying 5/16 of an inch can constitute a waiver of statutory rights.[1081] Lengthy offering circulars which go unread by franchisees relying on franchisor verbal representations can actually be used to shield fraudulent actions by franchisors: "a party cannot reasonably rely upon allegedly fraudulent promises which are directly

1077. C. Dickinson Waters, *IPC Looks to Instill for Supply Chain Insight*, NATION'S RESTAURANT NEWS, Feb. 5, 2001, at 27.

1078. Gorenstein Enterprises, Inc. v. Quality Care-USA, Inc., 874 F.2d 431, 435 (7th Cir. 1989).

1079. *See*, MICHAEL S. GAZZANIGA ET AL., COGNITIVE NEUROSCIENCE 211-212 (2000) (selective attention and performance degradation resulting from input overload). *Cf.*, Dale Hattis & Sue Swedis, *Uses of Biomarkers for Genetic Susceptibility and Exposure in the Regulatory Context*, 41 JURIMETRICS J. 177, 193-194 (2001) (costs of information disclosure and information overload: "warnings will be disregarded because it is too taxing for individuals to sift through it all").

1080. One attorney noted that the Arthur Wishart Act regulating franchise sales in Ontario "does require that the disclosure statement be accurate, clear and concise, which would indicate that many U.S. disclosure documents should not be used in Ontario." Edward N. Levitt, *How the Ontario Law Will Affect U.S. Franchisors*, FRANCHISE TIMES, Feb. 2001, at 42.

1081. EEOC v. Waffle House, 193 F.3d 805, 814 n.1 (1999) (King, J., dissenting), *rev'd on other grounds*, 534 U.S. 279 (2002).

contradicted by the terms of . . . a subsequently executed contract."[1082]

A third way in which disclosure may have unintended consequences is due to the manner of disclosure itself. Advertising is explicitly designed to accentuate the positive, and consumers would be expected to discount puffery accordingly. Even with regard to corporate communications directed toward investors, courts have held that claims may "be mere 'puffing' or sales talk upon which no reasonable person could rely."[1083] What is unique about the UFOC is that it is a large, formal legal document which many prospective franchisees erroneously assume is the end product of a process of governmental review: the cover may, for example, be plain save for a small company logo and a large boldface legend:

> Franchise Offering Circular
> For Prospective Franchisees
> As Required By The
> Federal Trade Commission[1084]

Of course, if one reads the FTC statement inside, it does say: "*We haven't checked it, and we don't know if it's correct* . . . . If you find anything wrong or anything important that's been left out, you should let us know about it."[1085] As noted during the 1999 Congressional hearings, the FTC is a toothless watchdog. In fairness to the FTC, the required FTC statement indicates that the FTC does not even bother to check the UFOC; and "The FTC does not require filings of franchise and business opportunity disclosure statements or offering circulars."[1086] Nevertheless, even a reasonably sophisticated reader might be puzzled by the incongruity of the formal presentation versus the disinterested ministerial tenor of a government regulator.

It is a legitimate debate as to whether the government should regulate franchising at all. But when one is given an impressive document "As Required by the Federal Trade Commission" given "To protect you"[1087] and given assertions by the franchisor that the franchisor can't do certain things (such as make earnings claims) because the government prohibits the franchisor from doing certain things—

1082. Carlock v. Pillsbury Co., 719 F. Supp. 791, 829 (D. Minn. 1989) (citing cases).
1083. Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1217 n.32 (1st Cir. 1996).
1084. Doctor's Associates Inc., FRANCHISE OFFERING CIRCULAR (1st ed. 2000).
1085. *Id.*, first page (unnumbered).
1086. Federal Trade Commission, *Franchise & Business Opportunity FAQs*, *available at* http://www.ftc.gov/bcp/franchise/faq1.htm.
1087. *See also* Susan P. Kezios, *"To Protect You . . ."—The Franchisee View of Pending Legislation*, FRANCHISING BUS. & L. ALERT, Oct. 2000, at 3.

franchisors and the FTC are being disingenuous if they believe the prospective franchisee is aware of the FTC's impotence. Moreover, it may be true—as one FTC official asserted to this author—that the mandate of the agency effectively ties the agency's hands (at best a debatable assertion in light of Section 5). However, the FTC is hardly clamoring for a broader mandate,[1088] raising concerns as to whether the agency's acquiescence is indicative of regulatory capture.[1089]

I. Electronic Disclosure

Recent legislation will have significant consequences for the current franchise disclosure regime.[1090] The late 1990s were a heady time when the "new economy"[1091] (composed of "e," "i," "b2b," and "b2c" businesses operating in "real time") created a need for a "new paradigm" where "surfing" the "information superhighway" would carry the "virtual" nation across the "bridge to the twenty-first century." Once the hype and techno-babble died down, it turned out that the fundamentals of business and human nature were unchanged. Ill-considered federal and state laws enacted to encourage the growth of electronic transactions, including franchise purchase transactions, are the statutory hangover of the 1990's e-euphoria.[1092]

1088. On the contrary, the FTC told the GAO that it did not see the need to even investigate relationship issues. *See* GAO 2001 Report, *supra* note 217, at 23. And, of course, there is Mr. Toporoff's reluctance to harm franchisor sales. *See supra* note 891.

1089. A counter-argument might be that agencies simply do as directed by Congress, but the reality is that Congress does listen to concerns of regulators, whose agencies do lobby for expanded mandates and expanded budgets.

1090. *See generally* David W. Koch & Alan H. Silberman, *Online Disclosure and Contracting*, *in* GATEWAY TO THE FUTURE OF FRANCHISING, W-11 (2001). *See also* Devin Klein & David Koch, *The Electronic Franchise Agreement [Became] Reality October 1*, *in* FRANCHISING WORLD, Sept. 2000, at 21. A significant issue is the erosion of privacy in the electronic age: franchisors soliciting EU residents are bound by privacy statutes even if data stored in the US. *See* http://www.export.govv/safeharbor. Many US franchisors operate in Canada, governed by similar Canadian law. *See* http://www.privcom.gc.ca.

1091. A recent government conference discussed b2b—the most recent trend. *See* Federal Trade Commission, *Entering the 21st Century: Competition Policy in the World of B2B Electronic Marketplaces* (Oct. 26, 2000) *available at* http://www.ftc.gov/os/2000/10/b2b/report.pdf (report of June 29-30, 2000 conference).

1092. *See generally*, H.R. REP. NO. 106-462 (1999) (discussing birth of information society); H.R. REP. NO. 106-341 (1999) (dollar volume of e-commerce); S.REP. NO. 106-131 (1999) (projections of growth in online transactions). The bubble burst the following year. *See Internet Shakeout Quickens During 'Brutal' First Half*, WALL ST. J., July 5, 2001, at B7 (over 550 dot coms shut down in previous year and a half); Molly Williams, *Little Gain, Less Venturing: Company Investments Slow*, WALL ST. J., July 5, 2001, at C1 (write-downs of Internet portfolios, and noting that Wells Fargo alone took $1.13 billion charge primarily due to such investments). *See also*, Toni Scott Reed, *Bond Claims and the Impact of the Uniform Electronic Transactions Act, the Uniform Computer*

Some law borders on the bizarre: computers can form binding contracts without human knowledge or assent.[1093] Documents affecting interstate commerce, including most franchise agreements,[1094] are covered by the federal "E-Sign" act:[1095] Human beings wishing to "sign" a contract may do so in any manner ranging from clicking on "I Agree" to belching into their computer's microphone—the only question for the court being whether the click/belch indicates the clickor's/belchor's intent to be bound.[1096] European Union states have implemented similar legislation.[1097] What is not addressed by the new legislation is the effect that electronic data will have on the disclosure process. Anyone who has ever read a newspaper online realizes that it is a different experience from reading one in paper format. It is questionable whether a prospective franchisee would actually read an online UFOC, or whether the franchisee would have any eyesight left if he or she did read several hundred pages. It is equally questionable that shifting the burden of printing the UFOC to the prospective franchisee would improve disclosure over the prior requirement that the franchisor give a printed copy of the UFOC to prospects. An additional problem arising in a 20-year contract may be that electronic data becomes inaccessible.[1098]

E-Sign will have a broad impact on the traditional solemnity associated with contract.[1099] Although the original purpose of the Statute of Frauds (1677) was evidentiary,[1100] the cautionary function of the

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Information Transactions Act, and Other Technological Developments, 36 TORT & INS. L. J. 735 (2001) This offers an overview of federal and state legislation. Note that Appendix A, at 773-776, offers a summary of state law. *Id.*

1093. Uniform Electronic Transactions Act § 14 (1999) ("A contract may be formed by the interaction of electronic agents of the parties, even if no individual was aware of or reviewed the electronic agents' actions or the resulting terms and agreements."). *Id.* Hereafter the act shall be referred to as "UETA."

1094. Kristine McKenzie, *New Law Paves Way for Electronic Franchise Agreement*, FRANCHISE TIMES, Jan. 2001, at 39.

1095. Electronic Signatures in Global and National Commerce Act, Pub. L. No. 106-229 (2000), *codified at* 15 U.S.C. §§ 7001-7031 (2000).

1096. *See* UETA, *supra* note 1093, at § 2, comment 7.

1097. *Directive 1999/93/EC of the European Parliament and of the Council of 13 on a Community Framework for Electronic Signatures*, (December 1999), *available at* www.netlaw.pl/e-podpis/esign-directive1999-en.html (last visited March 2003).

1098. New York State Bar Association, *Does Discovery of Electronic Information Require Amendments to the Federal Rules of Civil Procedure*, N.Y. LITIGATOR, Summer 2001, at 20, 21 (computer museums consulted for obsolete software & hardware to convert "Legacy data" to usable form). Issues also arise under Rule 34 of the Federal Rules of Civil Procedure (form in which documents produced) (*see* Williams v. Owens-Illinois, Inc., 665 F.2d 918 (9th Cir. 1982)). Who bears the cost of production takes on a new urgency when applied to legacy data (data stored in obsolete form) and metadata (embedded data not readily apparent to one party viewing the data).

1099. Patrick A. Randolph Jr., *Has E-Sign Murdered the Statute of Frauds*, PROB. & PROP., July-August 2001, at 23-27.

1100. E. ALLAN FARNSWORTH, CONTRACTS § 6.1 (3d ed. 1999).

statute is both beneficial to the parties and in the societal interest insofar as it minimizes litigation arising from misunderstanding or hasty decision-making. From the perspective of cognitive linguistics, a persuasive argument can be made for ceremony and solemnity.[1101] Even if one accepts the dubious proposition that electronic "signatures" are less likely to be forged than physical signatures,[1102] there is a psychological impact from physically signing a contract and obtaining the seal[1103] of the notary public. This psychological impact is not present in electronic transactions: people behave differently when dealing electronically.[1104] The instantaneous nature of electronic communications has led to foolish behavior and legally damaging consequences. Microsoft Corporation, epitome of the "new economy," is a case in point with negative consequences in antitrust[1105] and employment discrimination[1106] cases. Such flippancy can be seen in the use of passwords and electronic signatures: when President Clinton signed E-Sign into law, he did so using the electronic signature "Buddy"—the name of his dog.[1107]

The effect of E-Sign and its progeny will be to eliminate much of the cautionary effect of traditional written communications, personal signatures, and notarization of contracts. Hence, pre-contractual oversight becomes increasingly important if prospective franchisees are to be protected against abusive franchisors. Franchisors favor electronic disclosure, but oppose "pre-consent" of the franchisee to receive such disclosure, and McDonald's opposes a requirement that the franchisor provide a mere 3-page paper summary.[1108] This is precisely the type of issue in which regulators can distinguish between sophisticated and unsophisticated franchise purchasers and impose differing requirements.

1101. The late Senator S. I. Hayakawa discussed the origins, components, and modern application of this concept. *See* LANGUAGE IN THOUGHT AND ACTION 68-71(1990). On decision making and signing ceremony as ritual activity, *see* JAMES G. MARCH, A PRIMER ON DECISION MAKING (1994).

1102. Testimony of W. Hardy Callcott, Charles Schwab's General Counsel, H.R. REP. NO. 106-341, at Part 1 (1999); *accord*, Rebecca Porter, *Do Electronic Signatures Mean an End to the Dotted Line*, TRIAL, Sept. 2003, at 52, 54-55 (ABA Science & Technology Section claim of digital signature supremacy).

1103. Although state law may still require a notary, federal law provides that may be a "virtual" notary in the ether of cyberspace. *See* 15 U.S.C. § 7001(g) (2004).

1104. John Schwartz, *Loose Lips Sink More Than Ships*, N.Y. TIMES, July 8, 2001, at 4 (examples of e-mail gaffes and why psychology differs from composition of written letters or memos).

1105. Jerry Adler, *When E-Mail Bites Back*, NEWSWEEK., Nov. 23, 1998, at 45.

1106. Strauss v. Microsoft Corp., 856 F. Supp. 821, 825-26 (S.D.N.Y. 1994) (sexually explicit e-mail by Microsoft employee).

1107. Bill Zoellick, *Wide Use of Electronic Signatures Awaits Market Decisions About Their Risks & Benefits*, N.Y.S.B.J., Nov.-Dec. 2000, at 10, 11.

1108. *See* Stachowiak letters, *supra* note 10.

The FTC does not provide copies of UFOCs to researchers or prospective franchisees.[1109] One positive aspect of the Internet is that it would be possible for franchisors to file their UFOCs in electronic format (such as Adobe Acrobat) on the Internet in order that media and academic analysis could be done, as well as enable the prospective franchisee to compare franchises from across the nation, including some which the prospect may not have previously considered. However, franchisors are not likely to provide such informational access without regulatory mandate, and neither the NASAA nor the FTC has expressed a desire to impose a requirement.

VII. Conclusion

As this paper has shown, there is a history of franchisor abuse transcending temporal and spatial boundaries. Franchisor acceptance of the principles of good faith and fair dealing would go a long way to creating a more harmonious and profitable relationship based on trust; as a news article noted, the "invisible hand works because of the invisible handshake."[1110] The franchise industry understandably opposes regulation, and from an economic standpoint it would be more desirable to have mutual cooperation rather than legislation and private rights of action. A franchise chain in discord can be expensive for franchisor as well as franchisee.[1111] But the history of the franchise industry has been one of cleaning up its act only when confronted with the risk of legislative action. This accounts for the kinder, gentler, face of franchisors recently.[1112] Significant revisions have been proposed[1113] to the Federal Trade Commission (FTC) franchise disclosure regulations.[1114] Any regulatory regime must confront the issue of moral hazard. Too much regulation of franchisors would lead to franchisees not assessing and managing risk: paternalism creates perverse incentives.[1115] However, failure to regulate franchisors creates problems

1109. Federal Trade Commission. *Franchise & Business Opportunity FAQs*, *available at* http://www.ftc.gov/bcp/franchise/faq1.htm.

1110. David Wessel, *Invisible Hand Works Because of Invisible Handshake*, WALL ST. J., July 11, 2002, at A2.

1111. *E.g.*, *Shoney's Gets Debt Benefit in 2000; Capt. D's Comps Up*, NATION'S RESTAURANT NEWS, Feb. 12, 2001, at 12 (Shoney's fiscal year 1999 litigation costs $14.5 million, contributing to Shoney's net loss of $28.83 million).

1112. *Pundits Predict the Legal Trends*, FRANCHISE TIMES, Feb. 2003, at 28 (franchisor attorney Jeffrey Letwin stating franchisors and franchisees more willing to address issues in order to solve problems amicably and avoid national legislation).

1113. Franchise Rule, 64 Fed. Reg. 57,294 (proposed Oct. 22, 1999). *See also Public Comments, available at* http://www.ftc.gov/bcp/franchise/comments/tabcomm.htm.

1114. FTC Franchise Rule, 16 C.F.R. § 436 (2000).

1115. As already discussed, franchisors are often paternalistic in the pre-contract phase precisely to overcome franchisee concerns and sales resistance.

as well: failure of the government to recognize the abusive conduct of franchisors leads to a climate where franchisors are granted carte blanche, limited only by the most permissive state forum which the franchisor can justify in a choice-of-law clause. Even then, franchisor abuse will not even be at issue in a judicial forum unless the franchisee has the time and financial resources to bring the matter to light. Failure to regulate franchisors in an economy which permits franchisors to socialize the consequences of opportunism while benefiting from government tax incentives and government promotion of franchisors seeking to expand overseas also raises moral hazard issues, not to mention the hypocrisy of franchisors feeding at the public trough while championing the virtues of self-sufficiency.

Franchising has always been subjected to the threat of regulation and litigation.[1116] Most recently, the IFA adopted a franchisee-friendly image in response to the growing threat of federal legislation, even instituting an ombudsman program and inviting franchisees to participate as members. Franchisors have always pressed the limits of the law, seeking to exploit franchisee's sunk costs—tangible and intangible—in the franchise.[1117] The earliest industry to adopt franchising as a distribution model was the automobile industry. Inventor Henry Ford established distributorships,[1118] and when he had a falling-out with some of his original investors,[1119] two of them—the Dodge brothers—founded a competing auto company modeled after Ford. It was not long before Dodge Bros. litigated with an Atlanta franchisee[1120] in one of the earliest examples of abuse under a franchisor-friendly contract that rendered the franchisee's investment "somewhat precarious."[1121]

Franchisor abuse continued apace in the auto industry, and by 1956,

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1116. The earliest franchisor was Cyrus McCormick (McCormick reaper), and the first franchising case was probably Seymour v. McCormick, 57 U.S. 480 (1853). Of historical note is the Court's disapproval of the jury's "enormous and ruinous verdict"—it appears that excessive awards are not a recent phenomenon. *Id.* at 491.

1117. A McDonald's franchisee of 4½ years was required to buy-out his equipment at a value determined by the contract formula as $590,668, despite that McDonald's assessment of the market value was $315,000. When the franchisee failed to buy-out, the franchisee was left with nothing to show for 4½ years of work and McDonald's sold to a new franchisee for $315,000. McDonald's Corp. v. Barnes, No. 92-36552, 1993 U.S. App. LEXIS 23513, at *5 (9th Cir. Sept. 14, 1993). The case illustrates one franchisor's assessment of the hold-up value of a franchisee's sunk costs.

1118. David Gurnick & Steve Vieux, *Case History of the American Business Franchise*, 24 OKLA. CITY U. L. REV. 37, 45 (1999).

1119. Dodge v. Ford, 170 N.W. 668 (Mich. 1919).

1120. Ellis v. Dodge Bros., 246 F. 764 (5th Cir. 1917).

1121. *Id.* at 767. The lopsided contract is a precursor of the modern Franchise Agreement. Of note are franchisee claims of detrimental reliance and sunk costs. Also at issue was dealer termination that was arguably "unfair" even if permitted under the written agreement—identical to claims by franchisees today.

Congress was proposing legislation[1122] to "balance the power now heavily weighted in favor of automobile manufacturers"[1123] that failed "to act in good faith in complying with the terms of franchises or in terminating or not renewing franchises with their dealers."[1124] The legislative history makes findings virtually identical to many of the complaints voiced by franchisees today: when the president of the American Franchisee Association speaks of franchisor opposition to legislation in the year 2000 as being "the same old tired explanation,"[1125] she draws on a long history of franchisor opposition. The auto dealer legislation passed, and remains on the books today,[1126] commonly known as the Automobile Dealers' Day in Court Act (ADDCA). Early challenges to the legislation address many of the issues raised by opponents of SBFA, and are an indication of the precedent available to courts ruling under a future version of SBFA.

Unfortunately, most franchisees remain in a "somewhat precarious" state. A franchisee who falls into disfavor with his franchisor will find the law to favor the wealthy franchisor. One favorite tactic is to place competing outlets within close proximity of the targeted franchisee (encroachment) in order to bankrupt the franchisee or at least force the franchisee to sell his business. Allied Domecq was alleged to have pursued such a tactic in *Harford Donuts, Inc. v. Dunkin' Donuts Inc.*[1127] In granting the franchisor's motion for summary judgment, the court took note of Dunkin's violation of its own Encroachment Impact Policy, but found that "even if Dunkin' was obligated to operate in accordance with the Policy, it confers no rights or obligations on the parties."[1128] With respect to the allegation that Dunkin' deliberately tried to force the franchisee out of his business, the court responded:

> Even accepting [the] allegations as true, [franchisees] still cannot recover. Although Dunkin' may have engaged in some *shrewd business tactics*, it was allowed to establish franchises wherever it saw fit. [This] illustrates the inherent conflict between franchisees . . . and franchisors like Dunkin', who seek to achieve the greatest market saturation possible . . . .[1129]

1122. S. 3879, 84th Cong. (1956).
1123. H.R. REP. NO. 84-2850 (1956), *reprinted in* 1956 U.S.C.C.A.N. 4596, 4596.
1124. *Id.*
1125. Kezios, *supra* note 79, at 32.
1126. 15 U.S.C. §§ 1221-1225 (2004).
1127. Harford Donuts, Inc. v. Dunkin' Donuts Inc., No. L-98-3668, 2001 WL 403473, at *1 (D. Md. Apr. 10, 2001). How Dunkin' Donuts could be obligated to operate in accordance with the policy and not have an obligation conferred on it is not explained.
1128. *Id.* at *5.
1129. *Id.* at n.13 (emphasis added).

The court identifies one of the key reasons why franchising is not a family partnership: the interests of the parties are in opposition, particularly in mature franchise systems. Franchisors make their money from two primary sources: initial entry fees (including transfer fees) and royalties.[1130] As new franchises are purchased, *franchisor* revenue increases. Unless sales increases outpace losses to encroachment, franchisee margins decline since fixed costs must be spread over a declining revenue base. At some point, incremental growth in market share does not make economic sense to the party who bears the consequence of declining or negative margins. This is particularly of concern to franchisees in low margin industries such as quick-serve restaurants (QSRs).

What the *Harford* court labeled "shrewd" is more accurately labeled bad faith. When sophisticated franchisors assure prospects that the franchise system has an encroachment policy, the franchisor is aware that "the express provisions of a contract may grant the right to engage in conduct that would otherwise have been forbidden by the implied covenant of good faith."[1131] Thus, the franchisor knows that the franchisee can be driven out of business at the whim of the encroaching franchisor.

The absence of legal recourse to encroached franchisees is a serious risk factor to a prospective franchise purchaser, who may be under the fatal misimpression that the FTC Franchise Rule and FTC Act will protect him. The authors met one franchisee who alleged a deceptive trade practice on the part of his franchisor. The franchisee, a non-citizen immigrant, had been told that the U.S. Government would do something about this. The franchisee told the authors that he would be complaining to the government, and showed a printout he had been given from an Internet site which said that franchisor practices were regulated under Section 5. Franchisees do believe that the FTC will protect them from deceptive practices in the franchise relationship, and the authors have never met a franchisee who has read the GAO report indicating

1130. For example, the Blimpie franchisor in 2001 had gross revenues of $30.7 million, of which $19.2 million came from continuing fees and $4.09 million from sales of franchises and subfranchises/license fees. *See* Paul Frumkin, *Private Investor Group Set To Buy Blimpie for $26M*, NATION'S RESTAURANT NEWS, Oct. 22, 2001, at 1, 71. Royalties may be direct (percentage of sales) and indirect (built-in to the wholesale cost of the product). While vendor "rebates" are not normally regarded as royalties, they should be regarded as such because the economic benefit to the franchisor is the same. Collection costs for this ongoing revenue stream are modest once the initial systems are in place, making franchised outlets more profitable and predictable than company-owned outlets.

1131. Richard L. Cohn & RLC Enterprises, Inc. v. Taco Bell Corp., No. 92 c 5852, 1994 U.S. Dist. LEXIS 334, at *21 (N.D. Ill. Jan. 10, 1994) ("A court can't redraft the agreement simply because one of the parties may have made an unwise bargain.").

otherwise.

The conceptual disconnect between regulators and franchisees was noted by one commentator who observed that the FTC had closed without comment an investigation into the Subway sandwich chain.[1132] The commentator then cited a Subway case involving a lawsuit between a landlord and Subway in which the disgusted judge observed (a year prior to Subway admitting to placing stores "any f***ing place we could"):[1133]

> [t]here can be little doubt that the real losers here are the subtenants [Subway franchisees] who opened a Subway business only to be subjected to inevitable failure because of unwarranted competition—not from other fast food chains, but from their own. In my view (obviously it is only mine, since the issue was not before the jury) if anyone merited punitive damages it was the [Subway franchisees] who lost everything . . . .[1134]

Franchisors such as Subway now contractually limit arbitrator's ability to award punitive damages, another disincentive to reining in franchisor abuse. In striking down a waiver of punitives in arbitration the Alabama Supreme Court observed that such limitations permit "rampant fraudulent conduct with few, if any, legal repercussions."[1135]

Regulatory equilibrium must take account of societal norms of responsibility and fair play. Punitive damages express societal norms and are imposed to deter abuse. Punitive damages are not a windfall for the aggrieved franchisee, and restricting punitives gives a green light to franchisors seeking to exploit franchisees.[1136] Moreover, if the legislature finds a pattern of punitives unjustly enriching a single member of an aggrieved class, it may balance the interests of society and the franchisee victim by means of a split-recovery statute.[1137]

1132. Peter C. Lagarias, *Relationship Abuses and the GAO Report: Taking Another Look at the Findings*, FRANCHISING BUS. & L. ALERT, Sept. 2001, at 3.

1133. Behar, *supra* note 46, at 130.

1134. Lagarias, *supra* note 1132, at 3 (citing Jannotta v. Subway Sandwich Shops Inc., 125 F.3d 503, 518 (3d Cir. 1997) (Manion, J., concurring)).

1135. Cavalier Mfg., Inc. v. Jackson, 823 So.2d 1237, 1248 (Ala. 2001). *See also id.* at 1245 (decision of October 5, noting Alabama statute and public policy disfavor enforcement of predispute arbitration clauses). The following week, the court expanded its reasoning in holding that it would be just as violative of policy to waive the right to punitives in a judicial forum. *Ex parte* Thicklin, 824 So. 2d 723 (Ala. 2001) (decision of October 12, *withdrawn, rev'd on other grounds*; provision barring punitives severed but rest of mandatory arbitration clause enforced).

1136. *See* David G. Owen, *A Punitive Damages Overview: Functions, Problems and Reform*, 39 VILL. L. REV. 363, 377-78 (1994) (potential punitive award deters business by threatening profitability of wrongful action).

1137. Split recovery statutes provide that the state gets a portion of any punitive award. *See generally* Tony Wright, *Two Courts Uphold Statutes Giving Part of Punitive Awards*

Neither the Dunkin' nor the Subway franchisees would have conceived that they were entrusting their life savings to persons who were out to drive them into penury. In *Harford Donuts*, the franchisee was shown a written Encroachment Impact Policy, which the franchisor violated with impunity. Recently, one franchisor has begun to site stores less than four blocks apart in New York City, effectively putting franchisees in competition with each other in an already brutally competitive, high-cost market. It should be noted that the friendly local face of the distant franchisor is deceiving: In *Harford Donuts*, the court questioned, *sua sponte*, the authority of the local Dunkin' Donuts representative to bind Dunkin' Donuts.[1138] In the case of Subway, the local franchisor representative (who is de facto a franchisee) is under intense pressure to saturate the market, irrespective of objective business conditions and damage to franchisees.[1139] McDonalds franchisees in Brazil allege that not only did McDonalds encroach to the point of "cannibalization" (a Sao Paulo franchisee claimed a 60%), but it did so with company-owned stores whose rent was less due to the fact that the franchisor effectively places a mark-up on franchisee rents which is of course absent from direct landlord-franchisor agreements.[1140]

Such overreaching echoes the attitude that led to the ADDCA and PMPA. The response to SBFA exemplifies the attitude of franchisors fighting to lower taxes on the estates of millionaires while fighting to prevent raising a $5.25 per hour minimum wage.[1141] Certainly a case can be made for repeal of the estate tax and the ability of workers to live on $10,920 per year; the point here is that franchisors are wealth-maximizing and rent-seeking just as most other interest groups—

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to State, LAW. WKLY USA, Sept. 16, 2002, at 3 (citing DeMendoza v. Huffman, 51 P.3d 1232 (Or. 2002)); Evans *ex rel.* Kutch v. State, 56 P.3d 1046 (Alaska 2002). Only Alaska, Georgia, Illinois, Indiana, Iowa, Missouri, Oregon and Utah have split-recovery statutes. Bills are pending in New Jersey, California, and Texas. Wright, at 3.

1138. Harford Donuts, Inc. v. Dunkin' Donuts Inc., No. Civ. L-98-3668, 2001 WL 403473, at n.9 (D. Md. Apr. 10, 2001). The court adopts a belt-and-suspenders approach; there is just no way the franchisee could have won in that court, though in fairness, it was a motion for summary judgment. *Id.*

1139. *In re* Doctor's Assoc., Inc. and Tom O'Neill and Scott Linkletter, Bus. Franchise Guide (CCH) ¶ 12,098 (Resolutions LLC, Filed June 1, 2001).

1140. CCH NO. 266, *supra* note 626. It should be noted that business conditions in Brazil likely had a significant impact on the sales decline, but this is all the more reason to avoid encroaching on already struggling franchisees. *See McD Brazil Faces Franchisees' Lawsuits*, NATION'S RESTAURANT NEWS, Jan. 14, 2002, at 56 (noting forty-four outlets in litigation, competing franchisee group disapproves of litigation).

1141. Fisher, *supra* note 305 (firm scheduled meetings to lobby Representative Tim Holden (D-PA) against "Coble-like legislation. We have also lobbied against increases on [sic] the minimum wage. . . ."). *See also* Sparks, *supra* note 948 (IFA letter to franchisees soliciting franchisee members with promise that IFA will work to "protect our businesses from . . . minimum wage hikes").

including franchisees. One key difference is that franchisees are generally individual members of their local community and hence more likely to be influenced by non-monetary social constraints.[1142] Franchisors may couch their behavior in discussions of laissez-faire and "the sacred principle of freedom of contract,"[1143] but the views espoused are no more meritorious than are those of the franchisees. Determination of the proper level of regulation necessarily involves value judgments: to what extent are we as a society willing to permit the type of behavior seen in *Bolter* and *Vylene*—when do we simply tell the victimized franchisee: "Tough."

Harris Research (the *ChemDry* franchisor in *Bolter*) actually tells prospective franchisees that it operates according to "Christian Principles"[1144]:

> We always practice, "Do unto others as you would have done unto you." To put this into its franchise context, you should never impose anything on a franchisee that you wouldn't be happy to impose on yourself. Be totally honest in all your dealings . . . . We ask ourselves the question—"This may be legal, but is it ethical?"[1145]

Florence Bolter probably asked herself the same question.

Public companies are subject to heavy regulation, and yet recent events have shown a level of moral rot in American business. A Delaware Chancery Court judge observed that:

> The after-the-fact threat of federal and state law liability can never be an efficient or adequate method by which to ensure corporate integrity. And quite bluntly, it is questionable whether costly government policies ought be directed at placing crutches under well-heeled investors who can walk for themselves.[1146]

Franchise regulation will never serve as a panacea for post-sale abusive practices by franchisors. Indeed, overregulation would be economically inefficient and harm the very same class it purported to help. But the current abdication of franchise regulation to the "reputational"

1142. Posner, *supra* note 95, at 153.

1143. Rupert M. Barkoff, *Government Regulation of the Franchise Relationship in the United States*, 8 J. INT'L FRANCHISING & DISTRIB. L. 82 (1994) (noting that franchise regulators have concluded the principle is inapplicable or inappropriate).

1144. *ChemDry, supra* note 122. The interviewee was likely meaning to cite *Matthew* 7:12, commonly known as the "Golden Rule." This same concept is found at *Leviticus* 19:18, in Rabbinic Judaism, the *Analects* of Confucius at 12:2, and the Buddhist *Dhammapada* at 10:129-130. The Golden Rule has a universal basis, however scarce in franchising. CHARLES PANATI, SACRED ORIGINS OF PROFOUND THINGS 95 (1996).

1145. *ChemDry, supra* note 122.

1146. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1402 (2002).

constraints of the marketplace is not working, and is not a proper role for any government regulator. A distinction can and should be made between a corporate entity putting a $50 million hotel property under franchised management and elderly Florence Bolter putting her life savings into a Chem-Dry franchise.

With the exception of Maryland, no state Attorney General has expressed concern about franchisor abuse of small franchisees less able to fend for themselves. Many franchisees are not "well-heeled" investors but middle class citizens and immigrants who get less protection investing their life savings in a franchise than a corporate law firm senior partner investing in 100 shares of IBM. One of the few states to recognize this is California, which has sometimes declined to follow the North American Association of Securities Administrators. However, a leading franchisor lobbyist reports that industry discussions with California regulators will likely result in a climate "much more pleasant for franchisors."[1147]

An oft-quoted passage from *The Federalist* is James Madison's observation that "If men were angels, no government would be necessary."[1148] Notwithstanding franchisor invocations of Jesus Christ, franchisors are no angels. When the federal watchdog's priority is avoiding "a negative impact on franchise sales," one wonders if the watchdog has turned into a lapdog. If a government official tasked with regulating the franchise industry believes that Mrs. Bolter should be left to the tender mercies of a franchisor backed by an army of lawyers and Washington lobbyists, then the regulator is more properly at home in private practice. (The same would be true of a regulator who overly favored franchisees, but with the possible exceptions of California and Maryland no state regulator is regarded by franchisors as a serious check on franchisor overreaching.)

At a Practicing Law Institute seminar on franchising, a law student intern from the New York Attorney General's office was asked what he had learned during the two days. He responded: "Don't buy a franchise." The next time you meet a franchisor attorney, ask him or her if they have ever owned a franchise. Ask whether they would tell their brother or sister or neighbor to buy a franchise from one of the franchisors they represent and whose contracts they draft. It is a poor reflection on the franchising industry that increased knowledge leads to more cynicism. Justice Thomas is correct that "Cynicism is one of the

1147. *Well Worth the Wait: Wrapping Up 2002's 20 to Watch*, FRANCHISE TIMES, Feb. 2003, at 8 (quoting Neil Simon of the National Franchise Council, a trade group of the largest franchisors).

1148. THE FEDERALIST No. 51, at 290 (James Madison) (Clinton Rossiter ed., 1961).

leading causes of the death of dreams."[1149] The franchise industry has been relatively successful in keeping from the public and legislators the true nature of what goes on in franchising, and for that reason highly-respected politicians accept industry campaign contributions and oppose regulation of the "American Dream." It would behoove the industry to clean its house before truth leads to cynicism and the death of franchisors' dreams of wealth. For Congress to *depend* on franchisors to see that need for reform is to ignore half a century of history.

The auto and petroleum industries have balanced legislation which provides all parties with a profitable relationship. The IFA protests that this is not possible for non-auto/non-petroleum franchisors since, they claim, franchising is not an industry and as the "voice of franchising," the IFA objects to the very notion. But just as the IFA takes positions in Congress and in court on behalf of the franchise industry, so to can Congress pass legislation governing the franchise industry.

This paper has shown a pattern by the franchise industry to claim that franchising is a "unique" relationship, a "partnership" between franchisor and franchisee. The case law has shown that the franchise industry ceases making those claims as it enters the courthouse door. It may be that "there's a sucker born every minute"[1150] but this does not excuse the conduct of abusive franchisors, nor the failure of franchisor trade associations to take a position in favor of fair dealing. It is difficult to define good faith and fair dealing, but far simpler to cite examples of the bad faith all too common in the franchise industry.

Franchise legislation should not favor franchisors or franchisees. It should embody principles of responsibility and fair play. No relational contract can see twenty years into the future, and franchisors should have the ability to exercise discretion in the mutual interest of all parties. Franchisors will complain that relationship legislation, with its concern with good faith and fair dealing, will inject an element of uncertainty into the franchise relationship. But there is already an element of uncertainty: it exists in the mind of the franchisee living each day with the knowledge that a capricious franchisor may rob the franchisee of a life's savings—with an approving nod from the courts and regulators. The *Chem-Dry* franchisor said: "This may be legal. But is it ethical?"

1149. Clarence Thomas, Speech before the Savannah (Ga.) Bar Association Annual Lunch, DeSoto Hilton (May 11, 2001) (on file with the author).

1150. Attributed to P.T. Barnum, but probably never said by Barnum. *See* http://www.alt-usage-english.org/excerpts/fxtheres.html (last modified Sept. 19, 2001).

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