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Franchising Law in the United States Between Theory and Practice: Heads Up for Foreign Investors

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FRANCHISING LAW IN THE UNITED STATES BETWEEN THEORY AND PRACTICE: HEADS UP FOR FOREIGN INVESTORS

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ABSTRACT

As a dynamic vehicle for fostering investment opportunities, both domestically and internationally, franchising spans a diverse array of industrial sectors, encompassing both goods and services. The United States plays a highly influential role in global franchise industry promotion, with a vast majority of International Franchise Association members representing American companies. Present data underscores that franchising has extended its reach to virtually every sector of the American economy. Notably, the United States stands among just four common law nations that have established dedicated franchise legislation, operating at both state and federal levels. This framework includes provisions for pre-sale disclosure, registration of franchise offerings, and the regulation of contractual relationships between the parties involved.

Gaining a firm grasp of the pertinent federal, state, and case law surrounding franchising, especially for foreign investors, contributes significantly to establishing credibility and garnering respect. With the aim of offering a thorough insight into the fundamentals of franchising from a legal standpoint in the U.S.A., this article delves into several key aspects. These include the components of a franchise as defined by both federal and state laws, the extent of these laws'

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applicability, the incentives and support mechanisms designed to encourage foreign investment in the franchising sector, and the regulatory framework governing franchise relationships. While adhering to the framework presented above for introducing and analyzing franchising in the U.S., specific observations come to light.

I. INTRODUCTION

Franchising is a business tool in which a business owner, called the franchisor, allows another person, the franchisee, to trade in his goods or services in conformity with the franchisor's business plan and using his trademark. Franchising is a dynamic tool in promoting a country's investment opportunities as franchising encompasses almost all industrial sectors in both goods and services.[1] It can be found in automotive products and services, computer sales, construction and maintenance, legal services, fast food, and other industries.[2] Franchising helps a franchisor expand its business rapidly through a well-organized distribution system.[3] Franchising can also be an alternative to traditional methods of raising capital such as bank loans.[4] From the franchisee's perspective, franchising allows a franchisee to use a familiar or well-known trademark and to avoid having to spend large amounts of money on advertising and promotions.[5] Similarly, it allows a franchisee to become part of a successful business chain already mastered by the franchisor,[6] and to receive the technical assistance necessary to efficiently operate the franchised business such as guidance on store layout, design, and site selection.[7] Franchising, moreover, as a method of distribution, requires less capital investment than other methods like joint ventures.[8] Franchising also allows franchisees to invest in additional retail outlets in various foreign markets using the goodwill and brand of the franchisor.[9]

The United States is one of four common law countries that have franchise legislation and one of six countries that has revised its legislation since 2000.[10] According to the Central Intelligence Agency

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[1] Michael G. Brennan, *Franchising and Licensing: Their Relevance to Corporate Counsel*, 2000 BUS. L. INT'L 222, 223 (2000).
[2] Francine Lafontaine & Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States*, 3 ENTREPRENEURIAL BUS. L.J. 381, 387 (2009).
[3] ANDREW C. SELDEN ET AL., AN INTRODUCTION TO FRANCHISING 48 (3d ed. 2008).
[4] *Id.* at 3.
[5] ROBERT T. JUSTIS & RICHARD J. JUDO, FRANCHISING 2-3 (Robert LaManna ed., 3d ed. 2003).
[6] SELDEN ET AL., *supra* note 3, at 50.
[7] JUSTIS & JUDO, *supra* note 5, at 2-3.
[8] *Id.* at 2-4.
[9] SELDEN ET AL., *supra* note 3, at 3.
[10] ELIZABETH CRAWFORD SPENCER, THE REGULATION OF FRANCHISING IN THE NEW GLOBAL ECONOMY 215-16 (2010). According to Spencer, the six countries that

("CIA") World Fact Book, in 2021, the U.S. economy was the world's second largest, after the European Union, with a GDP of almost $21.132 trillion,[11] approximately 827 billion U.S. dollars coming from franchising. Moreover, the U.S. plays a very active role in promoting the franchising industry worldwide to the extent that 95% of the International Franchise Association's ("IFA") members are American companies.[12] Current statistics show that franchising now spans across almost all American economic sectors.[13] Franchising in the United States dominates, for example, in the hotel, fast food, gas, transportation, insurance, and construction industries.[14]

Franchising laws around the world usually regulate three areas: pre-sale disclosure, registration of franchise offers, and regulation of the relationship between the contracting parties. Disclosure laws mandate that franchisors disclose to potential franchisees any information that can be expected to affect the franchisees' decision whether to enter franchise transactions.[15] Disclosure laws are the most common among countries regulating franchising.[16] Approximately thirty countries have specialized franchising laws and, of those, nineteen have only disclosure laws.[17] Registration laws are not usually found independent from disclosure laws. Hence, registration regulations typically mandate that franchisors submit their disclosure documents, along with information regarding their intellectual property, and occasionally records concerning their brokers, if any, to an authorized government registration agency. This is done before franchisors can proceed with making franchise sale offers.[18] Registration is usually required for authentication purposes.[19] Finally, few countries have franchisor-

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reviewed their franchise legislations since 2000 are Mexico, Spain, China, Taiwan, Japan, and the United States of America. *See id.* at 215. Also, the four common law countries that have franchise legislation are Canada, Australia, Barbados, and the United States. *See id.* at 216.

[11] *United States*, WORLD FACT BOOK, https://www.cia.gov/the-world-factbook/countries/united-states/#introduction (last updated June 30, 2023).

[12] *Id.* at 328.

[13] *Id.* at 391.

[14] Susan Grueneberg, *Food Trucks and Franchising: A Recipe for Success?*, SNELL & WILMER L. (2010), http://www.swlaw.com/assets/pdf/news/2010/10/01/FoodTrucksandFranchisingARecipeforSuccess_WEB.pdf.

[15] SPENCER, *supra* note 10, at 227.

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

franchisee relationship laws. Relationship laws usually regulate the performance of the franchise relationship after a franchise agreement has been finalized. Relationship laws elaborate on issues such as the rights and obligations of the franchising parties, renewal and transfer of a franchise agreement, good faith performance of the agreement, and the methods available for settling disputes arising out of the performance of a franchise agreement.[20] The focus of most relationship laws is termination.

It could be inferred that in the United States, franchising laws are generally divided into three categories: federal and state franchise disclosure and registration rules, state franchise relationship laws, and business opportunity laws. Additionally, there are specialized laws regulating specific franchising industries.[21] On December 21, 1978, the FTC promulgated its first set of disclosure and registration rules on franchising, called the "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" or the "Old Rule."[22] The Old Rule required the disclosure of specific information before a sale was concluded unless the transaction was exempted.[23] The FTC recently amended the Old Rule by adopting "The Disclosure Requirements and Prohibitions Concerning Franchising" or the "New Rule."[24] The New Rule took seventeen months to be fully implemented from the time of its adoption by the FTC. Franchisors were permitted to begin using the New Rule's disclosure format and procedures on July 1, 2007, and were officially obliged to comply on July 1, 2008.[25] Additionally, the Uniform Franchise Offering Circular ("UFOC") was introduced in 1986 to provide franchisors with an alternative means of disclosure.[26] Until 2007, the Commission permitted franchisors to comply with disclosure requirements by following either the provisions of the Old Rule or the UFOC guidelines, as they

[20] *Id.*
[21] *See generally* 15 U.S.C. §§ 1221-25 (detailing the Petroleum Marketing Practices Act and the Automobile Dealer Franchise Act).
[22] 43 Fed. Reg. 59,614 (Dec. 21, 1978).
[23] 43 Fed. Reg. 59,625-26.
[24] 16 C.F.R. § 436.1 (2007).
[25] THE FTC FRANCHISE RULE 2 (Susan Grueneberg & Ann Hurwitz eds., 2019).
[26] NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, THE UNIFORM FRANCHISE OFFERING CIRCULAR GUIDELINES (adopted by NASAA on April 25, 1993, Commerce Clearing House, 1993); *see generally FYI: Uniform Franchise Offering Circular (UFOC)*, FTC.GOV, https://www.ftc.gov/news-events/news/press-releases/1995/10/fyi-uniform-franchise-offering-circular-ufoc (Oct. 3, 1995).

maintain similar requirements.[27] The Federal Disclosure Documents ("FDD"), however, replaced the UFOC and has been the new disclosure standard since July 1, 2007.[28]

Beyond the federal requirements, many states have pre-sale disclosure and registration laws.[29] Fifteen states have laws requiring franchisors to disclose specific information material to franchisees when making franchise decisions.[30] State laws work as gap fillers for the federal disclosure and registration laws[31] and generally follow federal law with some differences regarding the definition and elements of a franchise, disclosure requirements, and exemptions.[32] A question here arises on the comprehensiveness of the U.S. federal and state law and its ability to meet investors, particularly foreign investors' expectations. Franchisors and franchisees usually prefer to have a very clear and comprehensive law instead of applying a variety of laws which may sometimes be confusing. In particular, though fifteen states in the United States have relationship laws, the United States law could be described as disclosure law. Conflict still arises between federal franchise rules and state disclosure and registration laws. The New Rule tried to address this issue by clarifying that it does not prevent application of any state franchise law unless the state law contradicts the New Rule.[33] The states must accept the federal rules as the baseline protections that must be conferred but are free to promulgate more restrictive rules.[34]

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27 *Id.*

28 ROCHELLE B. SPANDORF & MARK B. FORSETH, FUNDAMENTALS OF FRANCHISING 140 (Rupert M. Barkoff & Andrew C. Selden eds., 3d ed. 2008).

29 Brian B. Schnell & Sarah J. Yatchak, *Let's Make a Deal: Developing a Successful Franchise Resale Program*, 27 FRANCHISE L.J. 215, 217 (2008).

30 States with disclosure laws include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

31 Rupert M. Barkoff, *Franchise Sales Regulation Reform: Taking the Noose off the Golden Goose*, 3 ENTREPRENEURIAL BUS. L.J. 233, 246 (2009).

32 *Id.* at 249-50.

33 Gerald C. Wells & Dennis E. Wieczorek, *A Road Map to the New FTC Franchise Rule*, 27 FRANCHISE L.J. 105 (2007); *see also* Karen B. Satterlee & Leslie D. Curran, *Exemption Based Franchising: Are You Playing in a Minefield?*, 28 FRANCHISE L.J. 191, 195 (2009).

34 Wells & Wieczorek, *supra* note 33; *see also* David W. Oppenheim, *Changes in State Franchising Registration and Disclosure Laws as a Result of the Federal Trade Commission's Revised Franchise Rule*, 6 INT'L J. FRANCHISING L. 37 (2008).

For businesses investing in franchising in the United States, to maintain their status as the largest investors in the field worldwide, it is important to understand the fundamental legal and practical implications of doing franchising in the U.S. Understanding the relevant federal, state, and case law to franchising, particularly for foreign investors, creates a higher level of credibility and respect. This article introduces the concept of franchising and its essential elements in both federal and state law in an attempt to provide a comprehensive understanding of the cores of doing franchising from a legal perspective in the country (Part II). A clear explanation of the scope of application of the relevant laws, the persons addressed by those laws and the direct facilities and incentives to promote foreign investment in the franchising sector follows (Part III). Though the U.S. law is mainly a disclosure law, the U.S. state law includes, to a certain extent, some relationship rules on franchising which are analyzed and evaluated in detail in this article (Part IV). Though this disclosure law is considered as one of the most unique disclosure laws in the world, registration law still needs to be developed and various gaps need to be addressed as explained in detail in this article (Part V and VI). While following the above chart in introducing and analyzing franchising in the U.S., some recommendations are made from time to time to help fill any found weaknesses or proven gaps.

II. DEFINITION AND ELEMENTS OF FRANCHISING IN THE U.S. LAW

Generally speaking, a good definition of franchising is one that satisfies the legal elements of such a relationship—a distribution methodology in which the franchisor grants the franchisee the right to deal under the franchisor's trademark or trade name and following his business plan in return for an agreed amount of fees. The elements of franchising are fees, assistance and control, general use of intellectual property such as trademarks, and a business or marketing plan. The inclusion of these elements helps to distinguish franchising from other legal forms with common features but do not include all the franchising elements such as agency and transfer of technology.

A definition of franchising could be found in the state law, where most states recognize the said elements of franchising.[35] In

[35] BYRON E. FOX & BRUCE S. SCHAEFFER, FRANCHISE REGULATION AND DAMAGES 1009 (2011).

Beilowitz v. General Motors Corp.,[36] for example, the court decided that the contractual relationship between Beilowitz and General Motors was a franchise under the New Jersey Franchise Practices Act for various reasons, significantly that Beilowitz used the General Motors trademark for twenty-three years.[37] The court also accorded weight to the fact that the public associated Beilowitz's business with the General Motors trademark.[38] As exemplified in *Beilowitz*, a business transaction is deemed to be a franchise relationship according to the New Rule if it satisfies the elements mentioned above regardless of how the parties describe the relationship themselves and whether they perform the duties arising under this relationship.[39] Similarly, the relationship is not considered a franchise relationship, even if the parties call it a franchise, if it does not satisfy the elements of a franchise according to the New Rule.[40] Furthermore, a franchise agreement is not considered concluded until the franchise agreement is signed, even if the franchisee pays the fees before signing the agreement.[41]

The New Rule explicitly excludes from its scope employer-employee relationships, partnerships, cooperative associations, certification or testing services, and single trademark licenses.[42] According to the Franchise Rule Compliance Guide, such relationships have some similarities to franchises, but do not satisfy one or more of the franchise elements.[43] For instance, many factors should be considered in deciding whether a relationship is an employment relationship: the degree of control exercised by the master, whether the employee is paid a salary or a lump sum payment, whether the employee may be discharged without any liability of the employer, and whether the employee is required to invest money in the relationship.[44] Also, the Compliance Guide defines cooperative associations to include "agricultural cooperatives authorized by the Capper-Volstead Act, 7 U.S.C. § 291" and "retailer-owned cooperative chains."[45] The Compliance Guide

[36] 233 F. Supp. 2d 631 (D.N.J. 2002).
[37] *Id.* at 639-40.
[38] *Id.* at 642.
[39] 16 C.F.R. § 436.1(h) (2007).
[40] *Id.*
[41] 16 C.F.R. § 436.1(i).
[42] 16 C.F.R. § 437.2(4)(i)-(iii).
[43] *See generally* FED. TRADE COMM., FRANCHISE RULE COMPLIANCE GUIDE: 16 C.F.R. § 436 (2008) [hereinafter FRANCHISE RULE COMPLIANCE GUIDE].
[44] *Id.*
[45] *Id*. at 16.

provides the example of "Underwriters Laboratories" as a testing service and defines single trademark licenses as those that require the licensee to manufacture goods according to the licensor's instructions and where use of the mark is the principal purpose of the agreement.[46]

The element of control and assistance is the extent to which franchisors manage and direct different aspects of the franchised business.[47] In essence, control takes place through various activities such as assisting franchisees in choosing a location, preparing the premises, and fulfilling the requirements for design and appearance. Control could also include assisting to a certain extent with business operations, providing technical training for the franchisee's employees, and providing help with establishing accounting systems and marketing. The importance of control and assistance is that it ensures that franchisors maintain the goodwill of their businesses and protect use of their franchised trademarks. The New Rule provides that franchisors must exercise *significant* control and assistance in the operation of the franchised business.[48] Though the word significant is generally subjective, it requires a strong connection with the operation of the franchised business and is more than minor advice provided to the franchisee.[49]

A marketing plan outlines a method for operating the business according to the system determined by the franchisor.[50] It usually requires use of the franchisor's trademarks, business standards, product and service specifications, training systems, operation manuals, specific advertising systems, and other requirements determined by the franchisor to establish a consistent look across all the franchised outlets.[51] The California Franchise Relations Act considers a marketing plan the core of a franchise by explicitly incorporating it into the definition of a franchise. Under the California law, a franchise is an agreement in which a franchisor grants a franchisee the right to offer, sell, or distribute the franchisor's goods or services under a marketing plan

[46] *Id.*
[47] Mark H. Miller, *Unintentional Franchising*, 36 ST. MARY'S L.J. 301, 315 (2005). In the United States, for example, both the FTC Rules and state laws regulate business opportunities.
[48] 16 C.F.R. § 436.1(h)(2).
[49] Miller, *supra* note 47, at 320 (citing the Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,967. (Aug. 24, 1979)).
[50] *See, e.g.,* CAL. CORP. CODE § 31005 (West 2012); CONN. GEN. STAT. § 42-133e (2012).
[51] Rochelle B. Spandorf, *Franchise Player*, 29 L.A. LAW. 34, 37 (2006).

that is associated with the use of a trademark, service mark, or trade name.[52] A marketing plan exists not only when the franchisee is required to use the franchisor's business plan, but also when the franchisor makes use of the plan optional.[53]

A community of interests exists where there are shared financial interests in the success of the business, particularly when each of the parties is dependent on the other to some extent.[54] One can conclude that requiring a mutual financial interest guarantees a certain degree of seriousness of the contracting parties. In this regard, some states require a community of interests rather than a marketing plan.[55] In *Ziegler Co. v. Rexnord, Inc.*,[56] the Wisconsin Supreme Court articulated ten factors used to determine whether a community of interests exists: the relationship's duration; the scope and nature of the obligations of the parties; the time spent by the dealer to distribute the products in question; the revenue gained by the distributor; territorial exclusivity; the extent to which the distributor uses the other party's mark; whether the distributor invests his own money; the number of employees the distributor uses to perform his obligations under the relationship; the amount of money spent by the distributor on advertising; and any other services the distributor provides to the other party's clients in performing his obligations.[57]

Concerning the fees element, both federal and state laws emphasize fees as one of the basic elements when defining a franchise. Examining the New Rule, it does not only refer to fees while defining franchising, but also defines required payments to include any consideration the franchisee pays to the franchisor to obtain the franchise.[58]

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52 CAL. BUS. & PROS. CODE § 20001 (West 2012).

53 *See* To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 953 F. Supp. 987, 994 (N.D. Ill. 1997).

54 THOMAS M. PITEGOFF & W. MICHAEL GARNER, *Franchise Relationship Laws*, *in* FUNDAMENTALS OF FRANCHISING LAW 192-93 (Rupert M. Barkoff & Andrew C. Selden eds., 4th ed. 2015).

55 *See, e.g.,* S.D. CODIFIED LAWS § 37-5A-1 (2011); HAW. REV. STAT. § 482E-2 (2011); MINN. STAT. § 80C.01(4) (2012).

56 407 N.W.2d 873 (Wis. 1987).

57 *Id.* at 879. For other cases on community of interests, see generally Jonathan Solish & Bruce Napell, *What is a Franchise?*, 26 FRANCHISE L.J. 3 (2006).

58 The New Rule provides that "[r]equired payment means all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease." *Id.* at § 436.1(s).

Therefore, the New Rule encompasses all payments, whether they are made directly by the franchisee or indirectly by a third party acting on their behalf. These payments can be in the form of a lump sum or installments, take any form, and are either explicitly stated in the franchise agreement or necessitated by the practical nature of the business.[59] Fees may include different forms of payments such as initial franchise fees, payments for advertising assistance, payments for rent, payments for required equipment and supplies, security deposits, escrow deposits, and royalties on sales.[60]

In *Adees v. Avis Rent-A-Car System., Inc.*,[61] Avis, a car agency operator, owned rental car locations and entered into an agreement with Adees titled an "Agency Operator Agreement" that required Adees to act as an operator for Avis without any commitment to pay initial fees.[62] Adees' commission, however, was supposed to be reduced by a $0.20 fleet surcharge per vehicle for each day the vehicle was assigned to the facility.[63] When Avis terminated the agreement, Adees claimed that Avis breached the franchising covenant of good faith because the agreement was a franchise agreement as, in Adees's opinion, it paid Avis two kinds of franchise fees: indirect fees represented by the $0.20 per car per day fleet surcharge that Avis deducted from Adees's commission and the fuel surcharge percentage split.[64]

The court decided that none of the claimed payments were actually franchise fees and, therefore, that the agreement was not a franchise agreement.[65] Regarding the fleet surcharge, the court explained that a variety of factors regulate when a fee is considered a franchise fee including whether the franchisor receives something of value in return for the fee, whether the party making the payment received something of value in exchange for the fee, if the fees paid are an irrevocable cost of doing the business, and whether the franchisee puts its own money at risk.[66] Applying these factors to Adees's claim, the

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[59] Miller, *supra* note 47, at 322-23; *see* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulations Rule, 44 Fed. Reg. 49,967 (Aug. 24, 1979) (to be codified at 16 C.F.R. pt. 436) (discussing the FTC's intent to capture all hidden franchise fees).
[60] Miller, *supra* note 47, at 322.
[61] 157 F. App'x 2, 2 (9th Cir. 2005).
[62] *Id.* at 3.
[63] *Id.*
[64] *Id.*
[65] *Id.* at 2-3.
[66] *Id*.

fleet surcharge cannot be considered a franchise fee because Adees received something of value in return for the fleet surcharge: the use of the cars that formed the basis for the commission.[67] The court also found that Adees had the choice to return any extra cars to Avis and to stop paying the fleet surcharge for these extra cars.[68] Moreover, the court explained that Adees did not invest any capital or buy any material from Avis.[69] Concerning the refueling surcharge commission split, the court found that it was not a cost that Adees had to pay as a license for operating Avis's business but rather an income gained from the activity of renting cars.[70]

Finally, licensing the use of intellectual property is the cornerstone of franchising transactions. For franchising purposes, the most important intellectual property licensed to the franchisee is the franchisor's trademarks or trade name and trade secrets or other proprietary information. Unfair competitive practices also bear a close relationship with the use of intellectual property. Discussing trademarks, undisclosed information, and unfair competition are out of the scope of this article.

No one can deny that the New Rule definition of franchising encompasses a comprehensive description of each one of the franchising elements. Nevertheless, it could be useful if the definition could explicitly exclude other forms of licensing transactions that have similar features to franchising.[71] For instance, many elements of franchising overlap with other forms of legal business transactions; this may cause confusion as to the nature of the transaction. A product franchise, for instance, is a distribution methodology that may cause confusion between franchising and distributorship agreements.[72] In distributorship agreements, distributors undertake to distribute goods in the name of the principal and, in product franchises, franchisees do the same.[73] In the same context, since franchisors exercise a degree of control over franchisees' process of operating the business, franchising may be confused with employment agreements.[74] Franchising may

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[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] Examples include agency and transfer of technology agreements.
[72] MARTIN MENDELSOHN ET AL., FRANCHISING LAW 45-46 (Martin Mendelsohn ed., Richmond Law & Tax 2d ed. 2004).
[73] *Id.*
[74] *Id.*

also be confused with agency, partnership, and sales representation.[75] Similarly, franchising transactions are often confused with licensing agreements because both kinds of transactions include the grant of a license for the use of a trademark, a name, or other forms of intellectual property rights.[76] Although the core of the franchisor–franchisee relationship is licensing the use of a trademark and the grant of know-how,[77] marketing and manufacturing are ancillary but crucial tasks as well.[78] This is contrasted with licensing where the main purpose is the manufacture of licensed goods.[79] As a result, franchising does not require the same level of prior experience in manufacturing that licensing needs.[80] In particular, franchisors have more control over the franchised business because franchisees need to follow the business systems or plans of franchisors, unlike licensors whose rights are only to supervise the use of the license in order to protect it and to collect royalties.[81] Franchising should also be distinguished from technology transfer agreements. A technology transfer agreement is a form of licensing agreement by which a license is given by the transferor to the transferee to establish a manufacturing unit to manufacture a product using the transferor's technology without having control over the way the licensee operates its business.[82] Nevertheless, a franchise agreement is only a limited license that allows the franchisor to authorize the franchisee to use the franchisor's trade name or mark to produce or distribute the franchisor's products or services where the franchisor has day-to-day control over the franchisee's operation of the business.[83]

III. SCOPE OF APPLICATION OF U.S. FEDERAL FRANCHISING LAW VERSUS STATE LAW

Discussing the scope of a given law helps determine which transactions the law regulates and accordingly, whether contracting

[75] *Id.*
[76] *Id.* at 47.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW [UNIDROIT], GUIDE TO INTERNATIONAL MASTER FRANCHISE ARRANGEMENTS 11 (2007).
[83] *Id.*

parties need to consider the law when concluding agreements. On the one hand, the U.S. franchise law applies only to franchises located in the U.S. or its territories.[84] Hence, the only relevant factor when discussing the scope of application of the U.S. franchising law is location of the franchise. It seems that the logic behind restricting the application of the U.S. franchising law to franchises located in the U.S. is the fact that foreign franchisees dealing with American franchisors outside the American territories are usually large and sophisticated investors who do not need to be protected by the U.S. law.[85] As one scholar suggests, the U.S. law seeks to deal only with domestic franchise issues and not franchises located abroad.[86]

On the other hand, the U.S. law provides for direct facilities and incentives to promote foreign investment in the franchising sector. For example, the Old Rule required that foreign franchisors submit audited financial statements, but complying with these auditing standards were burdensome to non-American investors.[87] Foreign investors had to hire American auditors to prepare and review the statements required by the Old Rule.[88] The New Rule resolved this problem by allowing the submission of audited financial statements accepted by the foreign franchisor's country so long as the statements met the requirements of the Securities and Exchange Commission.[89] The New Rule allows the franchisor to submit the disclosure documents within fourteen days of the franchisee paying any fees or signing the franchise agreement.[90] The New Rule also allows franchisors to first decide what type of agreement they will sign and then to place this information in the disclosure documents.[91] This reduces the start-up, research, and market survey expenses paid by foreign franchisors unfamiliar with the American market.

Finally, the New Rule does not require the parties to wait after negotiations to be able to sign the agreement, thus saving time and expediting the conclusion of the transaction.[92] Similarly, the New Rule

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[84] 16 C.F.R. § 436.2.
[85] THE FTC FRANCHISE RULE, *supra* note 25, at 6.
[86] *Id.*
[87] *Id.*
[88] Jan S. Gilbert & Suzie Loonam, *FTC Releases Franchise Rule Compliance Guide*, 28 FRANCHISE L.J. 20, 21-22 (2008).
[89] *Id*.
[90] 16 C.F.R. § 436.5(w).
[91] *Id.*
[92] *Id.*

allows for the electronic submission of disclosure documents, saving travel and shipping expenses.[93]

IV. THE MAIN FEATURES OF THE U.S. FRANCHISING STATE LAW AS RELATIONSHIP LAW

A. Liability

Discussing liability entails both liability arising during pre-contractual negotiations and liability arising during performance of the contract, both between the contracting parties and toward third parties. Finally, indemnity and insurance issues should be explored.

Franchising laws in the U.S. seem to leave issues arising before the official conclusion of a franchising agreement to be regulated by the general laws of contracts. Thus, neither the FTC nor state laws regulate disclosure requirements with respect to letters of intent. If, however, the letter of intent is binding, disclosure should be required.[94] Hence, the general rules provided by the FTC with respect to breach of disclosure requirements should apply. Liability arising from pre-contractual negotiations in franchising transactions is specifically addressed in *Goodman v. Dicker*.[95] In that case, the appellants, distributors for the Emerson Radio and Phonograph Corporation in D.C., tried to get a franchise to sell Emerson's products.[96] The trial court had decided that the appellants had acted in a way that encouraged the appellees to put more money into preparing for the franchise.[97] The Court of Appeals for the D.C. Circuit decided that this case involved pre-contractual representations and promises made by appellants that the franchise would be granted and that those promised had induced the appellees to take action.[98] The Court of Appeals affirmed the trial court’s decision that the appellants were liable for the money expended by the appellees in preparation to do business under the promised dealer franchise.[99] In contrast, contractual liability arising from

[93] 16 C.F.R. § 436.2(c).

[94] John R.F. Baer & Susan Grueneberg, *United States of America*, *in* INTERNATIONAL FRANCHISE SALES LAWS 20 (Andrew P. Loewinger & Michael K. Lindsey eds., 2011).

[95] 169 F.2d 684, 684 (D.C. Cir. 1948).

[96] *Id.*

[97] *Id.*

[98] *Id*.

[99] *Id.* at 685.

franchising agreements seems to be covered well by U.S. relevant laws. Thus, vicarious liability arises when a third party claims a franchisor is legally responsible for an act or omission of a franchisee or any member of the franchisor's network.[100] The common law rule is that franchisors are vicariously liable only when there is a relationship between the franchisor and the member that constitutes an agency relationship. In *Ellison v. Burger King Corp.*,[101] the Georgia Court of Appeals found that the franchisor was not responsible for a battery a Burger King manager committed against a customer who complained about a lack of service.[102] The court decided that the language of the franchise agreement was clear in establishing sole liability for employees of the franchisee.[103] The criteria for franchisors' vicarious liability is the existence of actual agency as discussed in the Restatement of Agency, which tests whether franchisors control the everyday operation of the franchised business.[104] It may be inferred that the franchisor's regular right to control the general operations conducted by the franchisee does not answer the question of the franchisor's vicarious liability. Thus, the type of matters to which the right to control extends shall be considered.

In *Exxon Corp. v. Tidwell*,[105] the Texas Supreme Court held that the proper standard to be used when the allegation is negligence in maintaining a safe workplace should be whether the franchisor had control over the safety and security of the premises, not just a general right of control.[106] Courts usually consider three elements when deciding apparent agency claims: (1) whether the franchisor consciously or impliedly represented the franchisee to be its agent; (2) whether a third party detrimentally changed his or her position in reliance on that representation; and (3) whether the third party reasonably relied on that

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[100] *See generally* Joseph H. King, Jr., *Limiting the Vicarious Liability of Franchisors for the Torts of Their Franchisees*, 62 WASH. & LEE L. REV. 417 (2005).
[101] 670 S.E.2d 469, 469 (Ga. Ct. App. 2008).
[102] *Id.*
[103] *Id.* at 821. Liability for employees includes hiring employees, observing their work, paying salaries, and determining the policies that apply thereof. *See id.*
[104] RESTATEMENT (THIRD) OF AGENCY § 7.06 (2005); *see also* Heather Carson Perkins, Sarah J. Yatchak & Gordon M. Hadfield, *Franchisor Liability For Acts of The Franchisee*, 29 FRANCHISE L.J. 174 (2010). *See generally* King, *supra* note 100, at 430-38.
[105] 867 S.W.2d 19, 19 (Tex. 1993).
[106] *Id.* at 23.

representation.[107] Still, courts are reluctant to consider using franchisors' logos as evidence of the existence of apparent agency.[108] For instance, in *Parker v. Domino's Pizza, Inc.*,[109] a Florida intermediate appellate court held that the existence of an agency relationship depends on the degree of control franchisors may exercise.[110]

In addition, direct liability arises in the case of injuries occurring on the franchise premises where franchisors breach their duties to third parties, directly causing injury.[111] Examples include instances where franchisors are liable for inspecting and fixing premises' defects or when franchisors are responsible for designing or constructing franchise premises.[112] In *Allen v. Greenville Hotel Partners*,[113] for example, the plaintiff claimed the franchisor was liable for injuries suffered in a fire that occurred at the franchise premises.[114] The plaintiff's main claim was that the franchisor had a duty to ask his franchisee to install sprinklers at the franchise premises.[115] The U.S. District Court for South Carolina held that the franchisor was not liable because asking franchisees for renovations was solely for the sake of maintaining the uniform appearance and operation of the hotel chain.[116]

Finally, franchise agreements typically include indemnification clauses requiring franchisees to indemnify franchisors for any settlements or judgments levied against franchisors for the franchisee's actions and costs associated with defending against those claims.[117] In addition, franchise agreements usually require franchisees to list franchisors as an additional insured on the franchisee's liability policy.[118] Passing the responsibility to the franchisee makes sense in a vicarious liability claim because it is the franchisee's negligence not the franchisor's that brought the franchisor into the litigation.[119] Many states in

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[107] Allen v. Greenville Hotel Partners, Inc., 409 F. Supp. 2d 672, 680 (D.S.C. 2006).
[108] Jay Hewitt, *Franchisor Direct Liability*, 30 FRANCHISE L.J. 35, 37 (2010); *see also* Perkins, Yatchak & Hadfield, *supra* note 104.
[109] 629 So. 2d 1026, 1026 (Fla. Dist. Ct. App. 1993).
[110] *Id.* at 1027.
[111] Perkins, Yatchak & Hadfield, *supra* note 104, at 177.
[112] *Id.*
[113] Allen v. Greenville Hotel Partners, Inc., 409 F. Supp. 2d 672, 672 (D.S.C. 2006).
[114] *Id.* at 673-74.
[115] *Id.* at 676-77.
[116] *Id.* at 677-78.
[117] Hewitt, *supra* note 108, at 35.
[118] *Id.*
[119] *Id.*

the U.S. require an explicit indemnification provision in the agreement for the franchisee's own negligence.[120]

To sum up, contractual liability concerning franchise agreements as well as indemnities are topics that are well addressed by U.S. law. It is only the silence of the U.S. law on disclosure requirements during pre-contractual negotiations that should be addressed. Lack of such rules could lead to increased opportunities for fraudulent actions by the contracting parties. It is noted in particular that the time before conclusion of a final agreement raises many issues that are not regulated by the classic rules of contract. Examples include rules applying to letters of intent, existence of pre-contractual disclosure obligations, and liability arising therefrom.

B. Remedies

Franchising law should have a comprehensive list of remedies available in case of breach of franchising agreements to give judges broad discretionary power and a variety of options when deciding remedies. A comprehensive list of remedies would also help reduce the chances of termination of the franchise agreement and allow parties to return to satisfactory contractual performance, a preferable outcome. In the United States, it could be inferred that remedies are available in different forms depending on whether the breach was of a franchise agreement, the franchise laws, or the disclosure and registration laws. Available remedies include injunctive relief, payment for goodwill, and repurchase of inventory. A good example of damages can be found in *Progressive Child Care Systems, Inc. v. Kids 'R' Kids International, Inc.*[121] In this case, the franchisee was operating the franchisor's two childcare facilities under the trade name "Kids 'R' Kids" in return for 5% of the enrollment-based revenue.[122] The franchisee stopped paying the franchisor royalties in March 2002 and started operating both facilities under the name "Legacy Learning Center."[123] Kids 'R' Kids claimed breach of contract, breach of personal guaranty, fraud, and conspiracy.[124] The jury awarded $1,385,008.72 to the

[120] Joyce Mazero, *Impact of Other Local Laws*, *in* FUNDAMENTALS OF INTERNATIONAL FRANCHISING 265 (Richard M. Asbill & Steven M. Goldman eds., 2001).
[121] No. 2-07-127-CV, 2008 Tex. App. LEXIS 8416 (Nov. 6, 2008).
[122] *Id.* at 2.
[123] *Id.* at 3.
[124] *Id.*

franchisor for past and future royalties.[125] The court of appeals of Texas affirmed and explained that under Georgia contract law (which governed the agreement) an injured party should be placed in the position in which it would have been absent the breach.[126] Applying this principle, the court found that the injured party could claim damages for lost profits which entitled the franchisor to an amount of money equal to lost future royalties.[127]

Injunctive relief is aptly explained in *Petro Franchise Systems, LLC v. All American Properties*, *Inc*.[128] In that case, the franchisor started providing competing products in the exclusive territory of the franchisee and the franchisee refrained from paying royalties.[129] After negotiations, the parties entered a settlement agreement that required the franchisee to pay the franchisor the late royalties and to release any claims, but the franchisee failed to fulfill his obligations arising out of the settlement agreement causing the franchisor to terminate the agreement and sue for a preliminary injunction under the Lanham Act to prevent the franchisee from using his trademark.[130] The franchisee claimed the franchisor breached its good faith obligation and accordingly sued for a preliminary injunction to prevent the franchisor from terminating the agreement.[131] While the court found there to be no dispute over whether the franchisee failed to pay royalties, it found that the franchisor correctly followed the termination procedure after the franchisee stopped paying.[132] Moreover, the court found that losing the franchise did not represent irreparable harm to the franchisee particularly because this harm could be compensated through monetary damages.[133] On the other hand, if the franchisee were to continue to use the franchisor's trademarks without authorization, the franchisor would suffer irreparable harm.[134] The court, therefore, granted the franchisor's request for a preliminary injunction.[135]

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[125] *Id.* at 4.
[126] *Id.* at 12.
[127] *Id.* at 12-13; *see also* Deborah S. Coldwell et al., *Franchise Law*, 63 SMU L. REV. 577, 604 (2010).
[128] 607 F. Supp. 2d 781 (W.D. Tex. 2009).
[129] *Id.* at 785-86.
[130] *Id.*
[131] *Id.*
[132] *Id.* at 789-91.
[133] *Id.* at 795.
[134] *Id.*
[135] *Id.* at 801.

One possible remedy for termination without good cause and for declining renewal is making the franchisor buy the franchisee's inventory.[136] Arkansas, for example, requires the franchisor to repurchase the franchisee's inventory if the franchisor ends the franchise agreement without good cause.[137] Michigan applies the same rule to both termination and non-renewal.[138] The inventory required to be repurchased by the franchisor varies. Connecticut, Hawaii, and Washington, for example, provide that inventory includes supplies, equipment, and furnishings.[139] Similarly, the financial compensation paid by the franchisor in such a case varies from one state to another. While California requires "the lower of the fair wholesale market value or the price paid by the franchisee," Connecticut requires "fair and reasonable compensation," and Michigan requires "the fair market value at the time of expiration of the franchise's inventory, supplies, equipment, fixtures, and furnishings."[140]

Finally, the issue of goodwill may be confusing sometimes as the term usually refers to a brand's value as associated with a trademark. Accordingly, goodwill is associated with the franchisor and not the franchisee. Some scholars interpret the goodwill rule in franchising on the basis that a franchisee also develops goodwill in the business called "sweat equity."[141] Sweat equity means building a value for the business without being associated with the trademark that reflects the "going concern" where franchisees build the success of their business on their own.[142] Illinois, for example, requires payment for goodwill in case of non-renewal.[143] Similarly, Hawaii requires payment for loss of goodwill in case of non-renewal unless one year of notice is given by the franchisor.[144]

C. Good Faith

The principle of good faith and fair dealing encompasses different standards that vary between civil and common law countries and

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[136] PITEGOFF & GARNER, *supra* note 54, at 210-11.
[137] ARK. CODE. ANN. § 4-72-209 (2012).
[138] PITEGOFF & GARNER, *supra* note 54, at 211.
[139] *Id.*
[140] *Id.*
[141] *Id.* at 212.
[142] *Id.*
[143] *Id.*
[144] *Id.*

depends on the nature and requirements of each contractual relationship. It could be inferred that the majority of civil law countries generally require good faith in contracts. Similarly, common law countries impose a duty of good faith and fair dealing in the performance and enforcement of contracts whether in statutes or through the courts.[145] In addition to the general rules regulating good faith and fair dealing, contracting parties usually include in their agreements a provision on good faith and fair dealing.[146] Good faith and fair dealing provisions in franchise agreements may be referred to explicitly, impliedly, or by reference.

In the United States, good faith and fair dealing with respect to franchise relationships is dealt with at different levels. Generally speaking, all contractual relationships, including franchise relationships, are subject to the statutory regulations and judicial principles governing contractual transactions, including good faith and fair dealing.[147] The Uniform Commercial Code ("UCC") defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[148] Also, the Restatement (Second) of Contracts imposes on the contracting parties the duty of good faith and fair dealing in performing their obligations.[149] The American jurisprudence understands the covenant of good faith and fair dealing as requiring the contracting parties to perform their contractual duties in an honest and reasonable way.[150] In *Brassil v. Maryland Casualty. Co.*,[151] the New York Court of Appeals confirmed the existence of an implied obligation of good faith in all written agreements.[152] In the same context, the federal District Court for the Southern District of Florida in *Allpattah Services, Inc. v. Exxon Corp.*,[153] held that an implied covenant of good faith and fair dealing prohibits either party from exercising

[145] Robert S. Adler & Richard A. Macc, *Good Faith: A New Look at an Old Doctrine*, 28 AKRON L. REV. 31, 42 (1994).
[146] Andrew Terry & Cary Di Lernia, *Franchising and the Quest for the Holy Grail: Good Faith or Good Intentions?*, 33 MELBOURNE U. L. REV. 542, 549 (2009).
[147] Joel Iglesias, *Applying the Implied Covenant of Good Faith and Fair Dealing to Franchises*, 40 HOUS. L. REV. 1423, 1433 (2004).
[148] U.C.C. § 1-201(b)(20) (2011).
[149] RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).
[150] Days Inn Worldwide, Inc. v. Sai Baba, Inc., 300 F. Supp. 2d 583, 590 (N.D. Ohio 2004).
[151] 104 N.E. 622 (N.Y. 1914).
[152] *Id.* at 624.
[153] 61 F. Supp. 2d 1308 (S.D. Fla. 1999).

discretionary powers granted by the contractual relationship in an unjust way.[154] Though the New Rule does not refer to the implied covenant of good faith and fair dealing,[155] good faith and fair dealing principles are dealt with explicitly at the state level and by specialized laws regulating specific franchising industries. Examples include specialized laws regulating specific franchising industries such as the 1987 Petroleum Marketing Practices Act ("PMPA")[156] and the 1956 Automobile Dealer Franchise Act ("ADFA").[157] While the PMPA addresses the arbitrary termination and non-renewal of franchise relationships,[158] the ADFA tries to create equilibrium between automobile producers and dealers by addressing the issue of good faith and providing for a cause of action in case of bad faith performance.[159] According to the ADFA, "good faith" means the obligation of franchise parties, employees, agents, and any other concerned party to act in a just way towards one another.[160] The PMPA's purpose is to keep the power balanced between the parties to gasoline franchise agreements.[161] Good faith under the PMPA is a subjective criterion that requires courts to test the intent of franchisors rather than their actions.[162]

In addition, many states have specialized franchise laws that regulate the substantive relationships, rights, and obligations among franchising parties.[163] These substantive state franchise regulations

[154] *Id.* at 1314.
[155] Frank J. Cavico, *The Covenant of Good Faith and Fair Dealing in the Franchise Business Relationship*, 6 BARRY L. REV. 61, 75-76 (2006).
[156] 15 U.S.C. §§ 2801-2806 (2012).
[157] 15 U.S.C. §§ 1221-1225.
[158] Mark J. Burzych & Emily L. Matthews, *Vive la Difference? Selective Enforcement of Franchise Agreement Terms and System Standards*, 23 FRANCHISE L.J. 110, 110 (2003).
[159] *Id.*
[160] 15 U.S.C. §§ 1221(e) ("'[G]ood faith' shall mean the duty of each party to any franchise, and all officers, employees, or agents thereof to act in a fair and equitable manner toward each other so as to guarantee the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party: *Provided*, That recommendation, endorsement, exposition, persuasion, urging or argument shall not be deemed to constitute a lack of good faith.").
[161] Saberi v. Shell Oil Prods. USA, No. C 04-2413, WL 646066 (N.D. Cal. Mar. 17, 2005).
[162] Cavico, *supra* note 155, at 67.
[163] *Id.* at 71.

usually require the franchising parties to act in good faith and consider fair dealing and reasonable commercial practices.[164]

The applications of good faith and fair dealing in contractual franchise relationships are extensive, encompassing various aspects such as advertising, payments, distribution processes, renovations, accounting, franchise agreement renewal, agreement termination, and pricing of goods.[165] In *Pinnacle Pizza Company, Inc., v. Little Caesar Enterprises, Inc.*,[166] Pinnacle, the franchisee, alleged that Little Caesar (LCE), the franchisor, breached the franchise contract and the covenant of good faith and fair dealing when it started using the advertisement slogan "Hot n' Ready," which was created by the franchisee, without obtaining the franchisee's permission.[167] The District Court for the District of South Dakota granted the franchisor summary judgment on all claims and the Court of Appeals affirmed.[168] The Court of Appeals explained that the franchisor's acts did not breach the covenant of good faith as they were in accordance with the franchise agreement that provided: "Franchise Owner expressly acknowledges that any and all goodwill associated with said Proprietary Marks, including any goodwill which might be deemed to have arisen or to arise in the future through the activities of any Licensee of LITTLE CAESAR, inures directly and exclusively to the benefit of LITTLE CAESAR."[169]

Territorial exclusivity may also run afoul of good faith and fair dealing in franchising transactions. The criterion for whether operating other franchises in the same area by the franchisor breaches the covenant of good faith and fair dealing is whether the franchise agreement explicitly provides for the franchisee's territorial exclusive right.[170] Thus, if the franchise agreement does not explicitly grant the franchisee an exclusive territory, the majority of U.S. courts will not

[164] *Id.* at 70. For instance, Washington requires the franchising parties to deal in good faith. WASH. REV. CODE § 19.100.180(1) (2012). Also, Iowa imposes on franchise parties a duty of good faith, which means, according to the language of the code, honesty and consideration of commercial fair dealing, whether in performing or enforcing the rights and obligations arising out of a franchise agreement. IOWA CODE § 523H.10 (2011). Moreover, Arkansas enjoins franchisors from dealing, except fairly and in good faith. ARK. CODE ANN. § 4-72-206(6) (2008).
[165] *See generally* Cavico, *supra* note 155.
[166] 598 F.3d 970 (8th Cir. 2010).
[167] *Id.* at 971.
[168] *Id.* at 981-82.
[169] *Id.* at 980.
[170] *Id.*

consider it a breach of the covenant of good faith and fair dealing if the franchisor were to open other franchises in the area.[171] A few courts, however, may consider it a breach of good faith for franchisors to operate other franchises in the same area, even where no territorial clause specifically forbids it.[172] In all cases, it is against good faith and fair dealing for the franchisor to grant proximate franchises in a way that causes loss to the franchisees and that prevent the franchisees from achieving the expected benefits of their operated businesses.[173]

Another application of good faith and fair dealing in franchise agreements relates to franchise fees. In *Shell Oil v. HRN, Inc.*,[174] the franchisees, HRN, claimed that their contractual inability to negotiate over the high franchised gasoline prices imposed by the franchisor, Shell, through the franchise agreements, was a breach of the UCC good faith and fair dealing principle.[175] The Supreme Court of Texas found that the price imposed by Shell was high;[176] however, the court decided that the UCC neither requires the price to be equal to a fair market price to be a good faith price, nor does it command a competitive price from every dealer.[177] Hence, the court concluded that Shell had not breached the good faith requirements of the UCC.[178]

Moreover, the covenant of good faith and fair dealing has many applications in the renewal of a franchisor-franchisee relationship. In *BP West Coast Products LLC v. Robert Greene*,[179] the franchisor, BP, notified its franchisee, Robert Greene, one year before the expiration of the franchise agreement, that it did not intend to renew the agreement, citing PMPA Section 2802(b)(3)(D), which allows the sale of a franchised premises as long as the sales decision is made in good faith and in the regular course of business.[180] BP asked the District Court for the Eastern District of California to rule that it had not breached PMPA when it refused to renew the franchise agreement[181] to which

[171] Cavico, *supra* note 155, at 86.
[172] *Id.*
[173] *Id.*
[174] 144 S.W.3d 429 (Tex. 2004).
[175] *Id.* at 432.
[176] *Id.* at 437.
[177] *Id.*
[178] *Id.* at 438.
[179] 318 F. Supp. 2d 987 (E.D. Cal. 2004).
[180] *Id.* at 992.
[181] *Id.* at 989-90.

Greene filed a counterclaim.[182] The court held that the criterion of good faith is subjective and governs intent rather than consequences as long as the franchisor does not act discriminatorily or outside the normal course of business.[183] The court decided that there had been no breach of the covenant of good faith and fair dealing and that BP's decision not to renew the agreement and to sell the premises was reasonable and not outside the normal course of business.[184]

D. Conclusion of a Franchise Agreement

The New Rule allows oral or written franchise agreements as long as the relationship satisfies the franchise elements.[185] Stated differently, a business transaction is deemed to be a franchise relationship under the New Rule so long as it satisfies the elements of a franchise regardless of the name the parties use to describe the relationship and

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[182] *Id.* at 990.

[183] *Id.* at 995-96. *But see* Iglesias, *supra* note 147, at 1451 (explaining that the criterion of good faith is whether the franchising agreement party maintaining discretion exercises it in a reasonable way or in contradiction with the reasonable expectations that are based not on subjective desires rather than economic facts).

[184] *Id.* at 996.

[185] 16 C.F.R. § 436.1(h). At the state level, however, the rule in respect of oral franchise agreement depends on each state law as some states recognize the enforceability of oral franchise agreements while others do not and a third category of states is silent on this issue. Nicole S. Zellweger, *Enforceability of Oral Franchise Agreements*, 28 FRANCHISE L.J. 136, 137 (2009). A good example of a state law that requires a franchise agreement to be in writing is Mississippi's franchise law which provides that: "'[f]ranchise' means a written arrangement for a definite or indefinite period." MISS. CODE ANN. § 75-24-51(6) (2012). Also, Virginia's franchise law defines a franchise as "a written contract or agreement." VA. CODE ANN. § 13.1-559 (2012). Examples of state laws that are silent on this issue include Indiana's franchise law that defines a franchise as "a contract," IND. CODE § 23-2-2.5-1 (2012), and Delaware's franchise law provides that "franchise means a contract or other arrangement governing the business relationship within this State between a franchised distributor and a franchisor." DEL. CODE ANN. tit. 6, § 2551(3) (2011). Courts, however, give strong attention to the parties' intent as to whether they plan to abide by an oral agreement. Zellweger, *supra*, at 180. In *R.G. Group, Inc. v. Horn & Hardart Co*., 751 F.2d 69, 75 (2d Cir. 1984), the U.S. Court of Appeals for the Second Circuit interpreted the New York law to mean that an oral agreement may be enforceable as long as the parties intend to make it binding and as long as they agree on all the significant provisions of the agreement. *See also* Zellweger, *supra*, at 180. Similarly, the enforceability of an oral franchise agreement depends on the course of conduct between the contracting parties. *See* Zellweger, *supra*, at 181.

whether the parties actually perform the duties arising under it.[186] Conversely, the relationship is not considered a franchise relationship, even if the parties call it one, if it does not meet the elements of a franchise.[187] The only formality recognized by the New Rule is that a franchise agreement is not valid until signed, even if the franchisee pays all the fees before executing the agreement.[188]

State law exhibits a considerable degree of similarity. In *Dunafon v. Taco Bell Corp.*,[189] for example, a federal district court in Missouri concluded that under Missouri law, a franchise agreement can exist without being in writing as long as the exchanged statements between the parties together with the course of conduct refer to the existence of a valid franchise agreement.[190]

A relevant issue is the duration of a franchise agreement. Many franchising laws require a minimum term for the franchise agreement, the violation of which may result in invalidation of the agreement.[191] The reason behind this rule appears to be the protection of franchisees that need to be given a proper amount of time to see the results of investing their capital in franchising transactions. Some developing countries also seem to view long-term agreements to be favorable as they often result in tax concessions.[192]

Applying this to both the New Rule and state laws, it appears that none have established any minimum period for a franchise agreement to be valid. This means the duration is determined by the will of the parties.[193] Although this does not align with the concept of freedom of contracting parties to set the term of their contract, requiring a minimum term for franchise agreements could be a good guarantee to protect franchisees against abusive or wrongful termination of a franchise agreement. In the same context, the renewal of a franchise agreement is regulated at the state level. Some states limit situations where franchisors may decline renewal to cases where good cause is shown and for only nondiscriminatory purposes.[194] Also, some states require

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[186] THE FTC FRANCHISE RULE, *supra* note 25, at 17-18.
[187] *Id.*
[188] *Id.* at 19.
[189] 691 F. Supp. 1232 (W.D. Mo. 1988).
[190] *Id.*
[191] UNIDROIT, *supra* note 82, at 48-49.
[192] *Id.*
[193] Craig R. Tractenberg, Robert B. Calihan, & Ann Marie Luciano, *Legal Considerations in Franchise Renewals*, 23 FRANCHISE L.J. 198, 198 (2003).
[194] *See* IOWA CODE § 523H.8 (2011).

notice of the franchisor's intention not to renew. Iowa law, for example, requires that the franchisee be "notified of the franchisor's intent not to renew at least six months prior to the expiration date or any extension of the franchise agreement."[195] Moreover, some states require franchisors to pay compensation for non-renewal.[196] The Washington Franchise Investment Protection Act, for example, makes it an unfair or deceptive act or practice or an unfair method of competition and therefore unlawful and a violation of this chapter for any person to: (i) Refuse to renew a franchise without fairly compensating the franchisee for the fair market value, at the time of expiration of the franchise.[197]

In *Thompson v. Atlantic Richfield*,[198] the U.S. District Court for the Western District of Washington concluded that the Washington Franchise Investment Protection Act does not allow automatic renewal of a franchise agreement after the lapse of its duration, but requires paying compensation to the franchisee for non-renewal.[199] In the same context, the Michigan Franchise Investment Law declares void any "provision that permits a franchisor to refuse to renew a franchise without fairly compensating the franchisee by repurchase or other means for the fair market value at the time of expiration of the franchisee's inventory, supplies, equipment, fixtures, and furnishings."[200]

Finally, the question of whether modifications can be required as a condition of renewal arises specifically in evergreen agreements and in jurisdictions that are reluctant to accept franchisors' economic interests as grounds for nonrenewal. Evergreen agreements are renewable regardless of whether the language of the agreement provides for renewal.[201] In such cases, to protect franchisors' rights to improve the franchise system, courts usually support the franchisor's right of conditional renewal even when such conditions are related to increased royalties, dispute resolution provisions, and the like.[202] The reason behind accepting such conditional renewal is to help franchisors achieve the expected effectiveness of the franchise operations.[203] In the same context, courts usually do not consider it a breach of good faith and

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[195] *Id.*
[196] *See* WASH. REV. CODE § 19.100.180 (2012).
[197] *Id.*
[198] 649 F. Supp. 969 (W.D. Wash. 1986).
[199] *Id.* at 973.
[200] MICH. COMP. LAWS § 445.1527 (2006).
[201] *Id.* at 198.
[202] *Id.* at 205.
[203] *Id.* at 205.

fair dealing when franchise agreements do not explicitly refer to a franchisor's right to modify the agreement in case of renewal.[204] Of course, franchisors must always consider the duties and obligations imposed by franchise laws in general. That includes observing anti-discrimination obligations against various franchisees or offering renewal to certain franchisees under certain terms and declining other franchisees' right of renewal under similar terms. It could be argued here that the U.S. approach concerning renewal of a contract sounds reasonable as it creates a balance between franchisors and franchisees' interests in renewal. Also, the U.S. approach allows for franchisors to decline renewal if they have good cause and the decision is made on a non-discriminatory basis, with written notice delivered at a reasonable time before termination. Otherwise, franchisees need to be compensated.

The transfer of a franchise agreement or allowing one of the parties to sub-franchise is important, particularly when a franchisor wants to replace the franchisee or a franchisee needs to quit and look for another person to take his place in the business. State law governs the issues of transfer and provides for a multitude of options. A franchisor cannot unreasonably withhold its consent to the transfer of the franchise. For instance, a franchisee may transfer the franchised business on condition that the transferee meets the reasonable qualifications of the franchisor so long as those qualifications are based upon legitimate business concerns.[205] For example, in *Mike Smith Pontiac, GMC, Inc. v. Mercedes-Benz of North America, Inc.*,[206] the Eleventh Circuit decided that the only reasonable grounds for a franchisor's objection to a transfer are the transferee's moral character or failure to meet the franchisor's written, reasonable, and uniformly applied standards or qualifications.[207] Additionally, the proposed transferee may need to meet all the requirements of the franchisor such as training programs, payment of transfer fees, and obligations imposed by the franchise agreement.[208] A franchisor must have good cause to decline a transfer.[209] Additionally, some states require franchisees to notify the franchisor of his intent to transfer the franchise and to include

[204] Payne v. McDonald's Corp., 957 F. Supp. 749, 758 (D. Md. 1997).
[205] IOWA CODE § 523H.5(1) (2011).
[206] 32 F.3d 528 (11th Cir. 1994)
[207] *Id.* at 531.
[208] IOWA CODE § 523H.5(3) (2011).
[209] HAW. REV. STAT. § 482E-6(2)(I) (2011).

specific information in the notice such as the transferee's name, address, and business experience.[210] In *Chrysler Corp. v. Bowshier*,[211] Bowshier filed a protest with the Ohio Motor Vehicle Dealers Board claiming that Chrysler neither approved nor refused the purchase transaction within thirty days of receipt of the transfer notice as required under the applicable regulation.[212] The Court of Common Pleas held that Chrysler had not violated the thirty-day notice requirement, because the period did not start until Chrysler received all the information it asked Bowshier to submit.[213] The appellate court reversed, reasoning that the thirty-day period starts when the franchisor receives written notice informing about the transfer.[214] Additionally, some states allow transfer to the franchisee's heirs on condition that the heirs satisfy the qualifications required of a franchise purchaser. Otherwise, they have the right to transfer the franchise to a third party who meets the requirements.[215]

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[210] The Arkansas Franchise Practices Act provides that "[i]t shall be a violation of this subchapter for any franchisee to transfer, assign, or sell a franchise or interest therein to another person unless the franchisee first notifies the franchisor of that intention by written notice, setting forth in the notice of intent the prospective transferee's name, address, statement of financial qualification, and business experience during the previous five (5) years." ARK. CODE ANN. § 4-72-205(a)(1) (2008). Similarly, the Iowa Code provides that "[a] franchisee shall give the franchisor no less than sixty days' written notice of a transfer which is subject to the provisions of this section, and on request from the franchisor shall provide in writing the ownership interests of all persons holding or claiming an equitable or beneficial interest in the franchise subsequent to the transfer or the franchisee, as appropriate." IOWA CODE § 523H.5(5) (2011).

[211] No. 01AP-921, 2002 Ohio App. LEXIS 1425 (10th Cir. Mar. 28, 2002).

[212] *Id.* at *1.

[213] *Id.*

[214] *Id.* at *8.

[215] Examples include Arkansas, California, Indiana, Nebraska, New Jersey, and others. Franchise Investment Law in California provides that "[n]o franchisor shall deny the surviving spouse, heirs, or estate of a deceased franchisee or the majority shareholder of the franchisee the opportunity to participate in the ownership of the franchise under a valid franchise agreement for a reasonable time after the death of the franchisee or majority shareholder of the franchisee. During that time the surviving spouse, heirs, or estate of the deceased shall either satisfy all of the then current qualifications for a purchaser of a franchise or sell, transfer, or assign the franchise to a person who satisfies the franchisor's then current standards for new franchisees. The rights granted pursuant to this section shall be granted subject to the surviving spouse, heirs or estate of the deceased maintaining all standards and obligations of the franchise." CAL. BUS. & PROF. CODE § 20027(a) (West 2012). Similarly, Indiana's Franchise Act provides that "[i]t is unlawful for any franchisor who has entered

Finally, termination of a franchise agreement is one of the most important issues that may arise with respect to franchise agreements because termination ends the franchising parties' relationship and all the rights and obligations attached. Hence, franchising laws have strict rules regarding termination in order to protect both contracting parties, particularly franchisees, against abusive termination and to reduce the number of disputes and amount of losses arising out of termination.

Franchisors are allowed to terminate the franchise agreement if they have good cause. The definition of good cause varies among the states. Some states define good cause as the franchisee's failure to comply with the franchisor's requirements.[216] Other states define good cause to include a franchisee's failure to satisfy non-discrimination requirements in the franchise agreement, failure to act in good faith, and voluntary acts impairing execution of the franchise agreement.[217] In *Betsy-Len Motor Hotel Corp. v. Holiday Inn, Inc.*,[218] the Virginia

into any franchise agreement with a franchisee who is either a resident of Indiana or a nonresident operating a franchise in Indiana to engage in any of the following acts and practices in relation to the agreement: . . . (3) Denying the surviving spouse, heirs, or estate of a deceased franchisee the opportunity to participate in the ownership of the franchise under a valid franchise agreement for a reasonable time after the death of the franchisee, provided that the surviving spouse, heirs, or estate maintains all standards and obligations of the franchise." IND. CODE § 23-2-2.7-2(3) (2012).

[216] The Minnesota Franchise Act provides that "[n]o person may terminate or cancel a franchise except for good cause. 'Good cause' means failure by the franchisee to substantially comply with the material and reasonable franchise requirements imposed by the franchisor including, but not limited to: (1) the bankruptcy or insolvency of the franchisee; (2) assignment for the benefit of creditors or similar disposition of the assets of the franchise business; (3) voluntary abandonment of the franchise business; (4) conviction or a plea of guilty or no contest to a charge of violating any law relating to the franchise business; or (5) any act by or conduct of the franchisee which materially impairs the good will associated with the franchisor's trademark, trade name, service mark, logotype or other commercial symbol." MINN. STAT. § 80C.14(b)(1)-(5) (2012). The Nebraska Franchise Act provides that "[i]t shall be a violation of [sections 87-401 to 87-410] for a franchisor to terminate, cancel or fail to renew a franchise without good cause." NEB. REV. STAT. § 87-404(1) (2012). The New Jersey Franchise Act provides that "[i]t shall be a violation of this act for a franchisor to terminate, cancel or fail to renew a franchise without good cause. For the purposes of this act, good cause for terminating, canceling, or failing to renew a franchise shall be limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise." N.J. STAT. ANN. § 56:10-5 (2012).

[217] ARK. CODE ANN. § 4-72-202(7)(A)-(C) (2008).

[218] 385 S.E.2d 559 (Va. 1989).

Supreme Court concluded that, although a franchise agreement cannot be terminated without "reasonable cause," the Virginia statute does not necessitate renewing a franchise agreement once it terminates.[219] Some states, such as Mississippi, do not have a good cause rule for termination.[220] For example, in *FMS, Inc. v. Volvo Construction Equipment North America, Inc.*,[221] FMS and Samsung Construction Equipment America Corporation entered into a dealer agreement under which FMS was authorized to sell Samsung's equipment.[222] Samsung, however, sold its entire business to Volvo which in turn undertook Samsung's contractual obligations to its dealers, including FMS.[223] Volvo, however, was allowed to manufacture and sell equipment under the Samsung name only for a period of three years and then would be required to market the equipment under its own name.[224] Volvo then terminated its contractual relationships with most of the Samsung dealers, including FMS.[225] Post-termination FMS brought suit against Volvo claiming termination without good cause.[226] Volvo argued that rebranded equipment under the Volvo name constituted a discontinuation of the franchise goods which in turn constituted good cause to terminate the dealer agreement with FMS under the applicable Maine law.[227] The Seventh Circuit reversed the decision of the district court deciding that Volvo was entitled to judgment in its favor as it had a good cause to terminate the dealer agreement.[228]

In its explanation, the appellate court cited the provision on good cause in the Maine law, which provides: "[t]here is good cause when the manufacturer discontinues production or distribution of the franchise goods."[229] The court explained that Volvo was required by the Maine law to continue to supply goods to FMS as long as it sold

[219] *Id.* at 559-61; *see also* Tractenberg et al., *supra* note 193, at 199; VA. CODE ANN. § 13.1-564 (2012) ("It shall be unlawful for a franchisor to cancel a franchise without reasonable cause or to use undue influence to induce a franchisee to surrender any right given to him by any provision contained in the franchise.").
[220] *See* MISS. CODE ANN. § 75-24-53 (2012).
[221] 557 F.3d 758 (7th Cir. 2009).
[222] *Id.* at 760.
[223] *Id.*
[224] *Id.*
[225] *Id.*
[226] *Id.*
[227] *Id.* at 762.
[228] *Id.* at 759.
[229] *Id.* at 760 (citing ME. REV. STAT. ANN. tit. 10, § 1363(3)(C), (3)(C)(4)).

the equipment under the Samsung name.[230] When Volvo started selling the equipment under its own name, though, that would be considered a discontinuation of the goods provided for in the dealer agreement and would constitute good cause to terminate the agreement with FMS.[231]

Examples of good cause include but are not limited to: franchisees underreporting sales to franchisors, failing to report profits to franchisors, submission of false information on profits, and failure to pay royalties or advertisement fees.[232] Market withdrawal can also be considered good cause. Several cases are now pending in jurisdictions that do not specifically authorize market withdrawal as grounds for termination and non-renewal.[233]

In addition to good cause, many states explicitly provide for good faith as a requirement to terminate a franchise agreement.[234] Moreover, some states require the franchisor to give the franchisee notice of its intent to terminate the franchise agreement. The notice duration varies among the states, but is usually thirty, sixty, or ninety days.[235]

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[230] *Id.* at 765.

[231] *Id.*

[232] *See generally* Crosthwait Equip. Co. v. John Deere Co., 992 F.2d 525 (5th Cir. 1993); Two Men & a Truck/Int'l Inc. v. Two Men & a Truck/Kalamazoo, Inc., 494 F. Supp. 500 (W.D. Mich. 1996); Dunkin Donuts of Am., Inc. v. Middletown Donut Corp., 495 A.2d 66 (N.J. 1985).

[233] Tractenberg et al., *supra* note 193, at 202.

[234] Examples include California, Connecticut, Delaware, Hawaii, Indiana, Michigan, and Minnesota. *See* ARK. STAT. ANN. § 4-72-202(8) (2008); CAL. BUS. & PROF. CODE § 20025 (West 2012); DEL. CODE ANN., tit. 6 § 2552 (2011); HAW. REV. STAT. § 482E-6 (1) (2011); MICH. COMP. LAWS § 445.1527(e) (2006); MINN. STAT. § 80C.01(4) (2012).

[235] The Illinois Franchise Disclosure Act of 1987 provides that it shall be illegal for a franchisor to terminate a franchise absent "good cause," which can arise when a franchisee fails to cure a default "after being given notice . . . and a reasonable opportunity to cure [the] default, which in no event need be more than 30 days." 815 ILL. COMP. STAT. § 705/19(a) (2012). Minnesota Franchise Law provides that "[n]o person may terminate or cancel a franchise unless: (i) that person has given written notice setting forth all the reasons for the termination or cancellation at least 90 days in advance of termination or cancellation . . . ." MINN. STAT. § 80C.14. The New Jersey Franchise Act provides that "[i]t shall be a violation of this act for any franchisor directly or indirectly through any officer, agent, or employee to terminate, cancel, or fail to renew a franchise without having first given written notice setting forth all the reasons for such termination, cancellation, or intent not to renew to the franchisee at least 60 days in advance of such termination, cancellation, or failure to renew . . . ." N.J. STAT. § 56:10-5 (2012).

Finally, many relationship laws grant franchisees time to cure any mistakes or deficiencies that may give franchisors the legal right to terminate or refuse to renew the agreement.[236] This period of time varies depending on the reason for the termination.[237] While the franchisor should try to give the franchisee a reasonable period of time, it is unreasonable to ask the franchisor to give the franchisee time in instances of insolvency, criminal actions, or repeated bad acts by the franchisee.[238]

In *LJL Transportation, Inc. v. Pilot Air Freight Corp.*,[239] the issue before the Pennsylvania Supreme Court was whether the franchisee's default, which was a breach of the agreement, gave the franchisor the right to terminate the agreement immediately despite its explicit provision that the breaching party could attempt to cure the default before the agreement would be terminated.[240] The Pennsylvania Supreme Court answered the question in the affirmative because Pilot Air Freight Corp., the franchisor, knew that LJL Transportation, the franchisee, had intentionally diverted shipments to another business to avoid reporting revenues and paying royalties to Pilot.[241] LJL argued that Pilot terminated the franchise agreement without giving it any chance to cure.[242] The court held that LJL's mistake was a fatal breach of the franchise agreement that gave the franchisor the right of immediate termination of the franchise agreement without providing notice or any reasonable period of time for the franchisee to fix his mistake.[243]

[236] FOX & SCHAEFFER, *supra* note 35, at 202; *see also* FUNDAMENTALS OF FRANCHISING, AMERICAN BAR ASSOCIATION: FORUM ON FRANCHISING (Rupert M. Barkoff et al. eds., 4th ed. 2015).
[237] ARK. CODE ANN. § 4-72-204(d) (2023); CAL. BUS. & PROF. CODE § 20020 (West 2016); HAW. REV. STAT. § 482E-6(2)(H) (2023); MICH. COMP. LAWS § 445.1527(c) (2023); MINN. STAT. § 80C.14(3) (2012); WASH. REV. CODE § 19.100.180(2)(j) (2011); WIS. STAT. § 135.04 (2011).
[238] FOX & SCHAEFFER, *supra* note 35, § 3.03.
[239] 962 A.2d 639 (Pa. 2009).
[240] *Id.* at 648.
[241] *Id.* at 644.
[242] *Id.* at 552.
[243] *Id.* at 652.

V. FEDERAL DISCLOSURE LAW IN THE UNITED STATES

It could be argued that disclosure is one of the most important issues arising in franchising to the extent that in some countries franchise laws are essentially disclosure laws.[244] Disclosure laws require franchisors to disclose to potential franchisees specific, material information that would highly affect the franchisee's decision whether to invest.[245] Disclosure requirements give franchisees access to necessary information about the franchised business, the franchisor, and the potential franchise agreement.[246] Having access to such information assists potential franchisees in reaching an informed investment decision and helps the franchisor to be more confident that the franchisee meets his requirements as he concludes the transaction knowing that all the necessary information has been disclosed by the franchisor.[247] Moreover, disclosure reduces the chances for fraud, misunderstanding between the contracting parties, and false expectations based on uncertain assumptions.[248] Further, disclosure reduces the chances the franchise will fail as both parties come to know all the necessary information about the other.

The issues required to be disclosed, the format of disclosure, and the language of disclosure vary from one country to another.[249] The most common issues requiring disclosure include information about the franchisor, such as the background of its officers and directors, litigation history, bankruptcy history, and financial statements. Disclosed issues also include information on the franchised system such as intellectual property information, advertising programs, and training programs. Moreover, information on franchisors' requirements from franchisees such as site selection, restrictions on sales, and initial investment are included. Finally, information on the proposed agreement such as initial fees, territorial rights, dispute resolutions,

[244] FEDERAL TRADE COMMISSION, DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING REPORT: STAFF REPORT TO THE FEDERAL TRADE COMMISSION AND PROPOSED REVISED TRADE REGULATION RULE 6-11 (16 CFR Part 436) (2004), available at https://webharvest.gov/peth04/20041023152038/http://www3.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.
[245] *Id.*
[246] *Id.*
[247] *Id.*
[248] *Id.*
[249] *Id.*

term, transfer, and termination of the agreement are usually included.[250] As explained earlier, the U.S. federal law is mainly disclosure law.

A. Scope of Disclosure Law

The New Rule is basically a disclosure law and applies to all franchise transactions located in the United States or any of its territories.[251] The New Rule, however, exempts from its scope of application various transactions that merit discussion. These exemptions are:

1. Minimum Payment Exemption

The FTC excludes transactions where required payments to the franchisor, made from any time before the transaction until six months after commencing operation of the franchised business, are less than \$615.[252] In other words, if the franchisor does not ask his franchisee to pay him or any of his affiliates more than \$615 within the first six months of operation, the deal is exempt under the FTC Rule. Though these kinds of transactions constitute franchise transactions, they include low risk of financial loss.[253]

2. Fractional Franchise

A fractional franchise is an extension of, or an addition to, a product or service that the franchisee is already offering to the public.[254] A fractional franchise is commonly found in grocery stores, hotels, universities, airports, or facilities where the product or service offered is within the confines of another business. The rationale for this exemption seems to be that the prospective franchisee should have the business acumen necessary to evaluate the costs, profits, and potential risks and benefits of the franchised business. Accordingly, the franchisee is unlikely to be misled through an incomplete or inaccurate disclosure.

To be considered fractional and qualify for an exemption from disclosure, a franchise must meet two conditions: "(1) The franchisee,

[250] W. Andrew Scott, Jeffrey H. Wolf & Allan P. Hillman, *Franchising from A(Arbitration) to T (Termination)*, 22 FRANCHISE L.J. 192 (2002).
[251] 16 C.F.R. § 436.2.
[252] 16 C.F.R. § 436.8.
[253] *Id.*
[254] *Id.*

any of the franchisee's current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business; and (2) The parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation."[255] Starbucks is a prime example of fractional franchising with almost 4,000 franchised outlets existing in various stores, hotels, and airports without submitting disclosure documents.[256] That is because Starbucks accepts applications from franchisees that already have their own business like bookstores where the cost of extending the services of Starbucks inside is low.[257] Thus, all that the franchisee incurs is the payment of royalties and other fees to the franchisor in addition to facilities, costs such as specific equipment because the franchisee already has the place, utility connections, employees, and other required facilities.[258]

3. Leased Departments Exemption

The leased department franchise relationship is also exempted from disclosure.[259] The leased department exemption refers to independent retailers who lease space from other larger businesses to sell their own goods and services, such as photography stores or beauty salons, in return for fees where the host businesses have a degree of control.[260] The leased department exemption is similar to the fractional franchise but without the 20% cap on gross sales.[261] This kind of business, however, is not exempted if the retailer asks the lessee to buy goods directly from him or his suppliers.[262]

4. Oral Contracts

The FTC excludes oral franchises that lack written evidence of the terms of the franchise agreement from the duty of disclosure.[263]

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[255] 16 C.F.R. § 436.1(g) (2007).
[256] Leonard D. Vines, Beata Krakus & Karen Satterlee, *Fractional Franchise Exemption: Friend or Foe?*, 30 FRANCHISE L.J. 72, 73-74 (2010).
[257] *Id.* at 73.
[258] *Id.*
[259] 16 C.F.R. § 436.8(a)(3) (2007).
[260] *Id.*
[261] *Id.*
[262] *Id.*
[263] *Id.* § 436.8(a)(7).

The logic behind this exemption seems to be the difficulty of proof arising in this type of agreement, particularly when it comes to enforcement. Accordingly, if there is any writing that may prove the terms of the agreement, the exemption would not apply even if the agreement lacks signatures.[264]

5. Petroleum Marketers and Resellers Exemption

Any transaction covered by the PMPA is exempted from disclosure requirements.[265] The reason for this exemption is that the PMPA has its own disclosure system.[266]

6. Sophisticated Investor Exemption

The sophisticated investor exemption means that franchisees, whether individuals or corporations, that have been in business[267] for at least five years and who have net assets of at least $6.165 million are exempted from the disclosure process.[268] The two requirements can be satisfied by parents or affiliates of the franchisee.[269] The net assets of the franchisee are determined through a balance sheet.[270] The significance of this exemption to foreign franchisors is that it requires only one investor from a group of investors to meet the requirement.[271] The basis of this exemption is that large and experienced entities such as hotels, corporations, and others can protect their interests without the need for disclosure.

7. Large Investment Exemption

[264] *Id.*
[265] *Id.* § 436.8(a)(4).
[266] *Id.*
[267] *Id.* § 436.8(5)(ii).
[268] *Id.* § 436.8(5)(ii); *see generally* Carl E. Zwister & Edward Levitt, *Amended U.S. Franchise Rule Breaks Down Barriers to Entering U.S. Market* (2007), https://www.dickinson-wright.com/-/media/documents/documents-linked-to-attorney-bios/levitt-ned/14-amended-us-franchise-rule-breaks-down-barriers.pdf?rev=306ffa1004ab44c1a25eaff8c92a465e&hash=872F8B4CC170837E5B239B1B16052608.
[269] *Id.*
[270] 16 C.F.R. § 436.8(5)(ii).
[271] *See generally* Zwister & Levitt, *supra* note 268.

The large investment exemption applies in cases where the initial amount invested is at least $1 million, excluding the cost of unimproved land and funds obtained from the franchisor or its affiliates.[272] In cases where a single franchisee is composed of more than one investor, at least one of the investors must invest at least $1 million; thus, a group of ten investors investing $100,000 each does not qualify for the exemption.[273] Additionally, the $1 million is calculated in light of the costs provided by the New Rule and not future franchisee obligations such as rent, royalties, or advertising.[274] The basis for this exemption is that franchisees initially investing large amounts of money are probably able to collect all the necessary information with regard to a franchised business even without a disclosure requirement.[275]

8. Officers, Owners, Managers Exemption

This rule aims at exempting franchisors from disclosure when selling at least 50% of the franchise to officers, owners, managers, general partners, or other individuals with management responsibility who, within sixty days of the purchase date, will have been working for the franchise unit for at least two years before purchasing the franchise from the franchisor.[276] The exemption also applies when selling the franchise to people who have owned at least a 25% stake in the franchise for a two-year period ending no later than sixty days before the sale.[277] Thus, the exemption applies to any person who acquires

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[272] 16 C.F.R. § 436.8(a)(5)(ii) ("The franchisee's initial investment, excluding any financing received from the franchisor or an affiliate and excluding the cost of unimproved land, totals at least $1,233,000 and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption. The acknowledgment shall state: 'the franchise sale is for more than $1,233,000—excluding the cost of unimproved land and any financing received from the franchisor or an affiliate—and thus is exempted from the Federal Trade Commission's Franchise Rule disclosure requirements, pursuant to 16 CFR § 436.8 (a) (5) (i).'").

[273] The rationale behind this rule, as articulated in the FTC Franchise Rule Compliance Guide, is that "[t]he large investment exemption is premised on the assumption that a franchisee's ability to pay a large sum equates with sophistication. That assumption fails when no one investor standing alone is investing at the requisite threshold level. For purposes of this provision, a husband and wife can be considered a single individual since their assets are typically commingled." *See* FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 43, at 12.

[274] *See generally id.*

[275] Satterlee & Curran, *supra* note 33, at 193.

[276] 16 C.F.R. § 436.8(a)(6).

[277] *Id.*

50% of the ownership in an American franchised company and operates it inside the United States.[278] It could be concluded that the basis of this exemption is that the franchisee is familiar with the franchise and is not in need of disclosure.

In the mid-1970s, franchise administrations in the states, working under the quasi-governmental North American Securities Administrators Association (NASAA), developed the UFOC disclosure guidelines to harmonize the disclosure requirements of the Old Rule and state disclosure rules.[279] The New Rule modified the Old Rule, which meant that the UFOC guidelines no longer met the requirements of the New Rule, leading NASAA to respond in June 2008 by issuing new guidelines that fit with the amendments provided by the New Rule and helped states to conform with the New Rule.[280]

Though some states adopted the new guidelines, other states still need to consider the New Rules because they retain some provisions inconsistent with both the New Rule and the 2008 NASAA Guidelines.[281] Some states, like South Dakota, which adopted a new franchise registration law, responded quickly in amending their disclosure rules;[282] others, however, still need to resolve lingering inconsistencies. In all cases, the New Rule provides a minimum standard of disclosure that states must uphold, but they are free to implement stricter requirements.[283]

9. Timing of Disclosure

The New Rule requires that disclosure take place fourteen days before paying the consideration, executing the franchise agreement,[284] or any time earlier if the franchisee reasonably requires disclosure.[285] Though the New Rule did not define a reasonable request, it is argued

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[278] *Id.*
[279] NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, THE UNIFORM FRANCHISE OFFERING CIRCULAR GUIDELINES (adopted by NASAA on April 25, 1993, Commerce Clearing House, 1993); *see generally* https://www.ftc.gov/news-events/news/press-releases/1995/10/fyi-uniform-franchise-offering-circular-ufoc (last visited October 6, 2023).
[279] *Id.*
[280] *Id.*
[281] *Id.*
[282] *Id.*
[283] SPANDORF & FORSETH, *supra* note 28, at 132.
[284] 16 C.F.R. § 436.2(a) (2007).
[285] *Id.* § 436.9(e).

that a request is not reasonable at least until discussions about purchase of the franchise take place. Moreover, the New Rule provides that if any material and unilateral changes or amendments are made by the franchisor, those changes have to be communicated to the franchisee seven days before signing the agreement.[286] Disclosure documents are considered delivered once they are delivered by hand, faxed, emailed, or sent to the address of the franchisee by first class mail "at least three calendar days before the required date."[287] The New Rule allows electronic disclosure through email and by allowing access to a website that has the disclosure documents.[288] In such a case, the New Rule requires that the franchisor use a format that allows the franchisee to store, download, or print the disclosure documents to be able to maintain them for future reference.[289]

B. Remedies

In the United States, if a franchisor fails to comply with the basic disclosure requirements it may be liable under the FTC Act.[290] These standards give the FTC the power to impose civil penalties of up to $10,000 per violation.[291] The FTC also holds the authority to mandate rescission, reformation, damages, or a blend of these remedies.[292] Moreover, the FTC can issue cease-and-desist orders.[293]

C. Information to be Disclosed

The U.S. law is very comprehensive and organized regarding what information must be disclosed. The New Rule requires a cover page before receipt of the disclosure documents that provides information about the franchisor, a sample of the trademark, a description of the business, the initial investment, the franchisee's contact information, and information for publication on the FTC's website and in its print publication.[294] All information must be written in plain

[286] *Id.* § 436.2(b).
[287] *Id.* §§ 436.2(c)(1, 3).
[288] *Id.* § 436.2(c)(2).
[289] *Id.* § 436.6(b).
[290] *Id.* § 436.6(a).
[291] 15 U.S.C. § 45(m)(1)(A).
[292] *Id.* § 57b(b); *see also* Judith M. Bailey & Dennis E. Wieczorek, *Franchise Disclosure Issues*, *in* FUNDAMENTALS OF FRANCHISING 91, 137.
[293] 15 U.S.C. § 45(b).
[294] 16 C.F.R. § 436.3 (2007).

language in a single document.[295] The New Rule also requires that the franchisor place each item under the appropriate heading to clarify whether the item is applicable to the situation and to avoid adding any information other than that required.[296]

The New Rule, furthermore, requires the franchisor to provide updated disclosure documents as of the close of the most recent fiscal year and to make revisions to the documents within 120 days of the most recent fiscal year.[297] Moreover, the franchisor is required to provide franchisees with revisions to the disclosure documents each quarter of the fiscal year.[298] The New Rule requires master franchisors to disclose in master franchise agreements information related to their sub-franchisors as well and not only information related to master franchisors.[299]

In addition, the New Rule requires a specific table of contents with certain information to be included in a specific order after the cover page and before mentioning disclosure items.[300] There are twenty-three items that require disclosure of different information.[301] Items one, two, and three require the disclosure of the franchisor's and any predecessors', affiliates', or agents' information.[302] It also requires disclosure of information about the franchised business such as type of business entity, location, the market of the franchised goods and services, and laws and regulations.[303] While item three requires disclosure of the litigation and arbitration history of the franchisor, item four asks for disclosure of the franchisor's bankruptcy history.[304] Items five, six, and seven demand disclosure of different financial issues related to the franchisor such as payments for goods or services provided by the franchisor, fees to be paid by the franchisee, and estimated initial investment amounts to be paid by the franchisee.[305] Item eight requires disclosure of the sources from which the franchisee is

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[295] *Id.* § 436.6(b).
[296] *Id.* § 436.6 (c)
[297] *Id.* § 436.7(a).
[298] *Id.* § 436.7(b).
[299] *Id.* § 436.6(f).
[300] *Id.* § 436.4.
[301] *Id.*
[302] *Id.* § 436.5(a)-(c).
[303] *Id.*
[304] *Id.*
[305] *Id.* § 436.5(e)-(f).

required to purchase or lease required supplies and equipment.[306] Regarding the franchise agreement, items nine through twelve deal with disclosure regarding franchise agreement information such as the franchisee's obligations, assistance provided by the franchisor, and exclusivity and any other territorial issues.[307] In addition, items thirteen and fourteen deal with aspects of intellectual property such as trademarks, service marks, copyrights, and patents.[308] Going back to the franchise agreement, item fifteen provides for disclosure of any obligations to participate in the operation of the franchised business.[309] In the same context, item sixteen requires disclosure of any restrictions with respect to the goods or services to be sold.[310] Likewise, item seventeen asks for disclosure of all information regarding renewal, termination, transfer, or dispute resolution.[311] Items eighteen and nineteen discuss miscellaneous issues such as information about public figures used in advertising and financial performance information such as past sales, income, and profits.[312] Item twenty concentrates on information about franchised outlets.[313] Item twenty-one goes back to financial issues and requires disclosure of the franchisor's financial statements for the last two years.[314] Item twenty-two asks for submission of a copy of all agreements related to the franchise offer such as the franchise agreement, any lease agreements, and purchase agreements.[315] Item twenty-three requests copies of the receipt of acknowledgment of the disclosure documents.[316]

VI. REGISTRATION LAW

In the United States, neither the New Rule nor any federal agencies deal with registration requirements.[317] Federal laws, however, do not prevent states from requiring registration[318] and the

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[306] *Id.* § 436.5(h).
[307] *Id.* § 436.5(h), (j).
[308] *Id.* § 436.5(m).
[309] *Id.* § 436.5(o).
[310] *Id.* § 436.5(p).
[311] *Id.* § 436.5(q).
[312] *Id.* § 436.5(r)-(s).
[313] *Id.* § 436.5(t).
[314] *Id.* § 436.5(u).
[315] *Id.* § 436.5(v).
[316] *Id.* § 436.5(w).
[317] SPENCER, *supra* note 10, at 147.
[318] *Id.*

registration requirements of fifteen states do not conflict with federal law.[319] Most states exempt specific transactions from registration. Exemptions vary among the states with the most common being the large franchisor exemption that is available to franchisors who meet specific minimum net worth and experience requirements.[320] The requirements vary from one state to another. Some states require a $5 million net worth, while others require $10 million. Some states require five years of experience, while others require a different number of years.[321] Another common exemption includes a sale of a franchise made by a franchisee for his own account.[322]

Franchisors submit registration applications to state agencies.[323] A registration application usually consists of a page giving information about the franchisor, a certification page signed by the applicant's representative before a notary public, an agreement for service of process which allows the service of documents upon the state authority as agent for the franchisor, and two copies of the disclosure documents. Additionally, there exists a supplemental information form that pertains to any prior denial of registration in another state, along with copies of advertising materials, the auditor's consent, application fees, and the sales agent disclosure form for sales agents authorized by the franchisor to promote the franchise within the state.[324] The application must also include a cover page encompassing all registered documents and a statement explicitly indicating that registration neither constitutes an endorsement of the franchise opportunity nor assures the accuracy of information within the disclosure documents.[325] Usually the review process takes a set period of time, the day after which registration becomes automatically effective.[326]

The registration agencies are usually granted the right to deny an application in various situations such as the franchisor's failure to comply with the state's law.[327] This also includes the situation where a person identified in the franchisor's application or disclosure

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[319] *Id.*
[320] SPANDORF & FORSETH, *supra* note 28, at 138.
[321] *See, e.g.,* CAL. CORP. CODE § 31101 (West 2012); N.D. CENT. CODE § 51-19-04 (2011); *see also* SPANDORF & FORSETH, *supra* note 28, at 138.
[322] CAL. CORP. CODE § 31102.
[323] SPANDORF & FORSETH, *supra* note 28, at 140.
[324] *Id.* at 141.
[325] *Id.* at 143-44.
[326] CAL. CORP. CODE § 31116(b).
[327] SPANDORF & FORSETH, *supra* note 28, at 144-45.

documents is convicted of a felony or found subject to liability in a civil action due to a cause related to the franchise's sale.[328] The reason behind allowing the registrar to deny the application in the latter situation is that allowing registration in this case may pose a risk to the prospective franchisee.[329] Registration usually expires at the end of the registration period, generally one year, unless renewal takes place with the addition of any changes that took place during the year.[330]

An amendment application must be filed to amend or change any of the information on the registration application.[331] Most states require franchisors to provide documents showing financial ability. The underlying motivation appears to be ensuring that franchisors can demonstrate their capability to fulfill the agreed-upon service obligations and offer adequate support to franchisees. This prevents undercapitalized franchisors from utilizing franchisees' initial fees for their own operational needs.[332] Alternatively, franchisors can show financial ability by offering a personal guarantor who audits the financial statement filed with the registration application.[333]

In the United States, disclosure laws can be violated in numerous ways, such as by franchisors failing to register their disclosure documents, intentionally hiding information, or providing false statements.[334] Enforcement powers take different forms that allow the competent authorities, for example, to issue cease-and-desist orders to prohibit franchise sales, to conduct investigations, to seek injunctive orders, and to obtain restitution on behalf of victims.[335] Criminal penalties are also available and violation of registration rules is usually punished as a felony.[336] Also, private remedies are allowed such as damages recovery, equitable relief, and rescission of the agreement.[337] A franchisor's failure to register disclosure documents, however, does

[328] *Id.*
[329] *Id.*
[330] *Id.* at 147.
[331] *Id.* at 149.
[332] *Id.* at 157.
[333] *Id.* at 157-60.
[334] PITEGOFF & GARNER, *supra* note 54, at 170.
[335] People ex rel. Dep't of Corps. v. Speedee Oil Change Sys., 95 Cal. App. 4th 709; MD. CODE ANN. § 14(b)(3); *see also* PITEGOFF & GARNER, *supra* note 54, at 170-71.
[336] PITEGOFF & GARNER, *supra* note 54, at 171.
[337] *Id.*

not make the franchise agreement null unless state law provides for the franchisee's right to void the agreement, typically for willful failure.[338]

Registration rules seem to be full of gaps. Registration regulations ought to mandate the submission of specific registration forms along with the disclosure documents, a duplicate of the franchise agreement, operational guidelines, training manuals, financial statements, and any supplementary documents as stipulated by the Registrar. Furthermore, submitting false or misleading documents should be a criminal offense. The law should determine the day registration becomes effective as well, which is likely the day mentioned in the written notice issued by the Registrar. The Registrar should be granted the right to withdraw registration if franchisors do not correct deficiencies once the Registrar notifies them. Also, franchisors should be required to notify the Registrar of any modifications or changes to the submitted documents. Additionally, the law should provide penalties for violating the registration rules, whether the violation was made by franchisors or Registrar employees. Furthermore, enforcement guarantees should be provided such as allowing the Registrar to conduct investigations including, if necessary, the power to enter the premises and to inspect, search, seize, and seal anything for the investigation. It is recommended to provide for the establishment of an advisory board composed of experienced experts in franchising to issue non-binding advisory opinions on issues related to franchising when required.

VII. CONCLUSION

This article examined and analyzed franchising law on both federal and state levels. Federal law is mainly disclosure law, while state law addresses, from time to time, some rules to help guide regulating the rights and obligations of the franchising parties. Though disclosure law as a federal law remains one of the most important and comprehensive laws worldwide, registration law needs improvement as explained. In particular, registration facilitates access to required information about the franchised business, which would in its turn help investors reach better decisions and build confidence in the relevant transactions. That is particularly relevant knowing that franchising relationships are usually the most appropriate transactions where

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[338] TKO Fleet Enter., Inc. v. Elite Limousine Plus, Inc., 708 N.Y.S.2d 593 (Sup. Ct. 2000); CAL. CORP. CODE § 31300 (West 2012); *see also* PITEGOFF & GARNER, *supra* note 54, at 173.

fiduciary obligations arise, such as non-competition or confidentiality provisions.

Similarly, one could argue that the U.S. franchising law is a disclosure law with no need to regulate relationship rules. In particular, the contracting parties in common law systems usually do not require regulating law that provides guidance on their transaction, rather agreements in common law countries are usually longer and contain more details than civil law agreements that usually include references to statutes or other legislative instruments as complementary documents. However, a compelling counterargument suggests that in almost all instances, well-crafted franchise agreements contain standard provisions, often derived from model laws, rather than being left to the discretion of the parties involved. To conclude, though considerations surrounding the drafting of a franchise agreement vary from one legal system to another, and from one case to the next, a good recommendation could be having solid relationship laws that cover all associated business and operational aspects of a franchise agreement.