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May 9, 2023

Federal Trade Commission

Re: Public Comment on Provisions of Franchise Agreements and Franchisor Business Practices

Dear Commissioner Khan and Members Slaughter and Bedoya

Thank you for soliciting comments on franchise agreements and franchisor business practices. For decades, the franchise industry has operated without any significant federal oversight. The Federal Trade Commission Franchise Rule is helpful in that it mandates certain pre-sale disclosure to prospective franchisees, but it suffers from two substantial problems. First, it has no private right of action and without aggressive federal enforcement franchisors have no obligation to ensure the information provided in the FDD is accurate and not misleading. Second, the Franchise Rule only addresses the franchise sales process and after the franchisee signs the agreement, they have no protection from a franchisor making arbitrary or damaging changes to the franchise system through the operations manual or franchise renewal agreements, even if those changes devastate franchisee profitability.

I am a second-generation franchise attorney. For more than 40 years, Bundy & Fichter has represented franchisees and franchisors in Washington State and around the country. As a child, every summer, I looked forward to attending the trade show for the 7-11 franchisee association and at Christmas, we enjoyed a honey-baked ham from one of our client's stores. I grew up in the franchise industry and I know how, for most franchisees, investing in a franchise means realizing the American dream of owning their own business and contributing to their community.

As a partner at Bundy & Fichter, I read hundreds of FDDs every year and work with franchise clients across industries. I've represented franchisors and franchisees in litigation, including one lawsuit where I represented twenty-four franchisee owner groups in eight states in a franchise fraud case. I've published articles in the Franchise Law Journal and spoken at the American Bar Association Forum on Franchising. I'm currently a member of the American Bar Association Forum on Franchising Governing Committee and the past chair of the Litigation and Dispute Resolution Committee. I co-authored the

Oregon chapter of the Franchise Deskbook and my partner, Howard Bundy, co-authored the Washington Chapter.

a. The Franchise Relationship

In your request for information, you asked for comments on the "the ability of franchisees to negotiate the terms of franchise agreements." In my experience, the vast majority of franchise agreements are presented on a take-it-or-leave-it basis. Many franchisors tell prospective franchisees that they will not negotiate franchise agreements. If the prospective franchisee is allowed to negotiate changes, the permitted changes are minimal tweaks to territory, initial fees or support. None of the changes affect the franchisor's ability to change the system through changing the operations manual, its unfettered discretion in enforcing the franchise agreement, the devastating impact of termination or non-renewal, and the fact franchisors profit from the franchisees' gross sales even if the franchisee isn't making any net profit. I tell my clients considering a franchise purchase that in terms of changes to the franchise agreement: they can change the color of the frosting but not the flavor of the cake.

The effects of franchisors' unwillingness to negotiate terms of the franchise agreement are pernicious and pervasive. Here are examples of common but fundamentally unfair terms in franchise agreements:

- Termination and Non-renewal-When a franchisor terminates or chooses not to renew a franchisee's business, virtually every system requires that the franchisee cease operations and abide by the terms of a non-compete. The franchisor may, but is not required to, purchase the terminated or non-renewed franchisee's equipment at its depreciated value and/or take over the lease but I am not aware of any system that adequately compensates the franchisee for the forced closure of their business in terms of goodwill or EBITA, even if the franchisor sells the unit to another franchisee or operates it as a company store. [1]
- Unlimited authority-Every franchise agreement includes a section where franchisees must agree to operate their business in "strict conformity" and comply with "every detail" of the operations manual or brand standards. One franchise agreement lists 22 areas of operation in which franchisees must strictly comply with the standards set by the franchisor.[2]
- Liquidated Damages and Early Termination Fees-Many franchisors require franchisees to operate their business for the full term of the franchise agreement or pay a stiff penalty which the franchisor describes as "liquidated damages" or an "early termination fee." One system charges a $150,000 early termination fee plus two years of technology and advertising fees per territory and prospective franchisees are told to purchase at least three territories! These fees apply even if the franchisee has never made a penny in their business. Because virtually every franchisor requires franchisees and their spouses to personally guarantee the franchise agreement, this means a franchisee who has spent their entire investment on operating a failing franchise must either liquidate their personal

[1] Examples of non-renewal and termination provisions are attached as Exhibit A.
[2] Examples of system compliance provisions are attached as Exhibit B.

> assets to support a failing business or use their personal funds (frequently retirement funds) to buy their freedom from the franchise agreement. A franchise agreement should not be a one-sided financial suicide pact.[3]

In the last decade of my practice, there has been a race to the bottom in terms of unreasonable terms in franchise agreements. Unfair and punitive terms that were once uncommon have become the industry standard. Prospective franchisees cannot shop around for better terms because the terms are present in virtually every agreement and franchisors refuse to negotiate.

Ironically, franchisors frequently criticize franchise regulations because they interfere with the ability of the franchisor and franchisee to establish the terms of the franchise relationship. Courts and arbitrators often cite the franchisees' ability to review the contract and propose minor changes as proof that the franchise agreement represents a negotiation between equals. Nothing could be further from the truth. Today's franchisors are large, sophisticated companies with significant legal and financial resources[4] represented by experienced sales teams but the franchisees are primarily individuals with limited business or ownership experience[5]. In fact, prospective franchisees are drawn to franchising because of their lack of prior business or industry experience.[6] In the early 20th century, industrialists fought wage and hour regulation by arguing that new regulations interfere with with "the freedom to contract" between employees and business owners. In reality, the workers had no meaningful freedom because poverty wages and poor labor conditions were almost universal. The unfair and damaging terms that franchisors foist on franchisees today would make a robber baron blush. They too should be consigned to history.

b. Non-disparagement and Goodwill Clauses

In your request for information, you asked for information related to the prevalence and enforcement of non-disparagement clauses. You asked, "to what extent do franchisors enforce non-disparagement, goodwill or similar clauses and how do they enforce them?" This is the wrong question. The mere presence of a non-disparagement clause in the franchise agreement has an immediate and devastating effect on the the franchisee's behavior. It prevents them from providing honest feedback to prospective franchisees and from reporting unfair and deceptive practices to federal or state authorities.

The International Franchise Association stresses that "it is the responsibility of each prospective franchisee to conduct a thorough due diligence of the franchise system."[7] But many (if not most) franchise agreements contain a "non-disparagement clause" which

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[3] Examples of liquidated damages and early termination provisions are attached as Exhibit C.

[4] Service Employees International Union, Petition for Investigation of the Franchise Industry, at p. 2 Indeed, the top twenty-five U.S. franchisors account for 21 percent of all franchised units in the country, with combined revenue over $50 billion. Id. at p. 4 (compiling data from each of the top twenty-five franchisors' FDDs and SEC Form 10-Ks). Attached as Exhibit D.

[5] Caroline B. Fichter, Don't Tread on Me: A Defense of State Franchise Regulation, 38 Franchise L.J. 1 (2018). Attached as Exhibit E.

[6] Robert W. Emerson & Uri Benoliel, Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws,76ALB.L.REV. 193, 203–04 (2013). Attached as Exhibit F.

[7] International Franchise Association, Statement of Guiding Principles. Attached as Exhibit G.

prohibits current and former franchisees from sharing their experiences. Below is an example of a typical clause:

> 6.6 Non-Contravention; Non-Disparagement. You shall not undertake any action or inaction to circumvent, contravene, or undermine the purposes of this Agreement. Additionally, during and after the term of this Agreement, You shall not, in any way, form, or medium, disparage Us, the System, the brand, or Our officers, owners, partners, directors, members, managers, representatives, agents or employees.

By signing the franchise agreement, the franchisee agrees to never "disparage" the franchisor, the brand or any person associated with the franchisor, even if the "disparaging" comments are true. Here's how this plays out in real-life. A prospective franchisee, Jane Doe, is invited to franchisor Brand X's "Discovery Day" where hand-picked franchisees share what a wonderful franchisor Brand X is, what great support they are getting and that they are making money. Brand X then gives Ms. Doe a copy of the FDD and tells them to call current and former franchisees and ask for their experiences. When she calls the former franchisees, they do not return her calls or won't speak with her because they have signed confidentiality agreements with Brand X. When she calls current franchisees, they provide vague answers, give positive feedback, or say that they are too busy to answer her questions. A Brand X representative may attempt to steer Ms. Doe to specific franchisees by setting up calls for her. What Ms. Doe does not know is that the hand-picked franchisees are outliers who don't accurately represent the system, or they have received special compensation such as free lodging or travel for their presentation. And the franchisees who do not respond or provide only vague comments are afraid of franchisor retaliation if they don't say good things about Brand X. In my litigation work on behalf of franchisees, I have frequently seen emails from disappointed franchise salespeople demanding to know which franchisee provided bad validation to a prospective franchisee and saying things like, "if prospects found out how stores were performing in this region, I'd never sell another franchise." Non-disparagement clauses avoid those problems by preventing current and former franchisees from providing honest comments during due diligence.

Returning to our example, say Ms. Doe purchases the franchise and liquidates her 401(k) (using a franchisor-suggested 401(k) rollover service) to fund her investment. After a few years, she discovers that the franchisor is not providing any meaningful support and the franchise system isn't working as well as the sponsored franchisees said it did. She also discovers that Brand X did not comply with the Franchise Rule. She wants to make a complaint to franchise regulators so that Brand X won't lie to anyone else. But her entire retirement is tied up in this investment and if she speaks up, she risks termination for violation the non-disparagement clause, the loss of her business, and liquidated damages. Ms. Doe stays silent and avoids calls from prospective franchisees of Brand X.

In my experience, franchisees who are willing to speak up and file a complaint with franchise regulators are party to the Bob Dylan rule because they got nothing and got nothing to lose[8]. I worked with several franchisees who filed a franchise fraud lawsuit against a franchisor and suddenly the franchisor was conducting "surprise inspections" of

[8] Bob Dylan, *Like a Rolling Stone, Highway 61 Revisited* (Columbia Records 1965)

their franchised businesses when, prior to filing the lawsuit the franchisor had given them awards for their store operations.

Non-disparagement clauses prevent franchisees from providing truthful information about the franchise system to prospective franchisees and franchise regulators. Confidentiality requirements in settlement and arbitration compound the problem and further deprive regulators and prospective franchisees of essential information. Franchisors are required to provide certain information related to resolved cases in their FDD but these descriptions are so frequently misleading that franchisee attorneys joke that they cannot recognize their own cases. But no one can alert regulators to the false description in the FDD because doing so would require them to break confidentiality and could jeopardize their settlement. Apparently, two *can* keep a secret if one of them is subject to a non-disparagement and confidentiality clause.

c. Other Issues and Concerns

Finally, you asked commenters to "comment on any issues…they believe are appropriate for our consideration." The FTC should investigate and consider regulating (1) the use of acknowledgments and questionnaires in FDDs and franchise agreements and (2) undisclosed relationships between franchisors and industry professionals such as franchise brokers, small business coaches, franchise "experts" and preferred franchise attorneys.

a. Misuse of Questionnaires and Acknowledgements

The FTC should strongly consider investigating franchisor's misuse of acknowledgments and questionnaires included in the FDD and franchise agreements to bar franchisee fraud claims. Virtually every FDD and franchise agreement contains provisions that require the prospective franchisee to acknowledge that they have reviewed the franchise agreement and are relying solely on the information contained in the FDD, that they understand that the success or failure of the franchise will depending on the prospective franchisee's skill and factors beyond the franchisor's control, that no representative of that no representative of the franchisor has made statements related to costs, sales, or profits that contradict or supplement information provided in the FDD[9]. Most franchisors also require prospective franchisees to complete a questionnaire, usually a series of yes or no questions, asking whether or not the prospective franchisee received unlawful financial performance representations, information about costs, or other information not contained in the FDD during the franchise sales process.[10] One franchisor-side law firm has noted that such acknowledgements and questionnaires create "an almost irrebuttable presumption" against a showing that a franchisee reasonably relied on a statement outside of the FDD[11]. Courts and arbitrators routinely hold that such acknowledgements and questionnaires bar franchisees' fraud and negligent misrepresentation claims as a matter

[9] Kerry Olson, Robin M. Spencer, Larry Weinberg, *The Annotated Franchise Agreement*, ABA 33RD ANNUAL FORUM ON FRANCHISING, at 102 (2016).
[10] Examples of acknowledgment and questionnaires are attached as Exhibit H.
[11] Eleanor Vaida Gerhards, John Gotaskie Jr., Natalma McKnew, Craig Tractenberg*, This New Year's Eve say Auld Lang Syne to Old Franchise Questionnaires and Acknowledgments*, https://www.jdsupra.com/legalnews/this-new-year-s-eve-say-auld-lang-syne-4538020/

of law[12]. These disclaimers and questionnaires give franchisors and franchise brokers the liberty to lie, knowing that the franchisee is unlikely to prevail on a franchise fraud claim--regardless of the strength of their evidence. One court noted that acknowledgments and questionnaires do not "change the historical fact of what representations were made" rather they attempt "to change the legal effect of those representations."[13]

Recently, the members of the North American Securities Administrators Association (NASAA) voted to adopt a Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments ("the SOP"). Under the SOP, franchisors in registration states will not be allowed to use questionnaires and acknowledgments in the franchise sales closing process or include similar questions and statements in their franchise agreements.[14] I strongly encourage the FTC to adopt a similar prohibition in all FDDs and franchise agreements.

b. Unregulated Franchise Development Companies and Other Franchise Professionals

Finally, the FTC should investigate and require more disclosure regarding the relationship between franchisors and companies and individuals that provide sales support, sponsored content, and "preferred" referrals for services to prospective franchisees. Many of my clients who come to me for an FDD review have worked with "business consultants" or "small business coaches." Sometimes, these coaches identify themselves as brokers but frequently they don't. My client believes that this franchise "professional" is providing guidance and expertise rather than leading them through a sophisticated sales process. Social media has also created opportunities for self-declared "franchise experts" to convince prospective franchisees to purchase specific franchises. For example, one franchise expert on twitter has more than 14,000 followers and describes himself as "building a franchise empire and helping others do the same." He offers followers a "free" newsletter, podcast and "franchise coaching" to help prospective franchisees "learn about emerging brands." He lists the brands he works with but doesn't disclose if those brands compensate him if one of his subscribers purchases a franchise. The FTC should strongly consider requiring these franchise experts to disclose if they receive any financial compensation from the brands they recommend or promote, similar to how the FTC has regulated sponsored content on social media.

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[12] *Motor City Bagels, LLC v. American Bagel, Co.*, 50 F.Supp. 2d. 460, 472 (D. MD 1999)(concluding that the plaintiff's alleged reliance on representations of average annual stores sales was unreasonable given disclaimer language in Item 19); *McCartin v. Westlake*, 630 N.E.2d 283 (Mass. App. Ct. 1994)(dismissing franchisees' fraud claims because franchisee had a no-representations acknowledgment); *Siemer v. Quizno's Franchise Co. LLC*, No. 07 C 2170, 2008 WL 904874, (N.D. Il. Mar. 31, 2008); *American's Favorite Chicken v. Cajun Enters. Inc.*, 1996 WL 306350 (E.D. La. 1996); *Sherman v. Ben and Jerry's*, No. 1:08-CV-207, 2009 WL 2462539, *3-6 (D.Vt. Aug. 10, 2009)

[13] *Randall v. Lady of America Franchise Corp*. 532 F.Supp.2d 1071, 1086-87 (2007), Solanki v. 7-Eleven, Inc., No. 12 Civ. 00027(LGS), 2014 WL 320236 (S.D.NY Jan. 29, 2014)

[14] NASAA Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments (available at https://www.nasaa.org/wp-content/uploads/2022/09/NASAA-Franchise-Questionnaires-and-Acknowledgments-Statement-of-Policy-9-18-2022.pdf

I have no doubt that the FTC will receive many letters from franchisors and their counsel stating that the current regulatory environment for franchising is working well and no additional enforcement is necessary. These letters are similar to the responses a farmer would get if she asked a group of foxes whether they think there should be more security at the henhouse. The current lack of enforcement from the FTC and the focus of the Franchise Rule on disclosure alone has encouraged the worst actors in the franchise industry to draft increasingly unfair franchise agreements, commit more disclosure violations and engage in more unfair and deceptive practices. The FTC using the tools it has to ensure that franchising is a fair deal for all the parties would be a significant step in the right direction.

Sincerely,

Caroline Fichter

Caroline B Fichter

condition, warranty or certification herein or fail to operate your Franchised Business as specified by us in the Operations Manuals and fail to cure such non-compliance or deficiency within thirty (30) days, or such other period of time as specified by applicable law, after our written notice thereof.

12.1.9. If you fail to pay any financial obligation pursuant to this Agreement or any other agreement with us within ten (10) days, or such other time period as specified by applicable law, of the date on which we give notice of such delinquency or immediately upon written notice if such payment has not been made within thirty (30) days after the date on which it is required to be paid.

12.1.10. If you fail to open your Franchised Business within ninety (90) days of the Effective Date, unless otherwise agreed in writing by us.

12.1.11. If you abandon or cease to operate all or any part of your Franchised Business under this Agreement for thirty (30) business days or longer (except as otherwise provided herein).

12.1.12. If you fail to meet your Monthly Purchase Requirement as provided in Section 2.6 of this Agreement.

12.1.13. If you or any guarantor(s) hereof default on any other agreement with us, or any affiliate or parent corporation of Franchisor in respect of any obligation related directly or indirectly to your Franchised Business, and such default is not cured in accordance with the terms of such other agreement.

12.2. Termination by You for Default. You may not terminate this Agreement prior to the expiration of the Initial Term or any renewal thereof except on the basis of our material breach of this Agreement and then only if you are not in default under this Agreement. In the event that you shall claim that we have failed to meet any material obligation under this Agreement, you shall provide us with written notice of such claim within sixty (60) days of its occurrence, specifically enumerating all alleged deficiencies and providing us with an opportunity to cure, which shall in no event be less than ninety (90) days from the date of our receipt of such notice from you.

12.3. Termination by Mutual Agreement of the Parties. The parties may mutually agree to terminate this Agreement.

13. POST TERM OBLIGATIONS

13.1. Obligations upon Termination or Expiration. Upon the termination or expiration of this Agreement for any reason, you shall immediately:

13.1.1. Cease to be our franchisee under this Agreement and cease to operate the Franchised Business. You shall not thereafter hold yourself out as our present or former franchisee;

13.1.2. Pay all sums owing to us. Upon termination for any default by you, such sums shall include actual damages, costs and expenses, including, without limitation, reasonable attorneys' fees, incurred by us as a result of your default;

13.1.3. Return to us the Operations Manuals, other Confidential Information, all trade secrets, and other property owned by us. You shall retain no copy or record of any of the foregoing, provided, however, that you may retain your copy of this Agreement, any correspondence between the parties and any other document which you reasonably need for compliance with any applicable provision of law. Business cards, brochures, marketing materials and other promotional materials also shall be returned to us or, in the alternative, you may certify to us that such items have been destroyed;

13.1.4. Take such action as may be required by us to transfer and assign to us or our designee or to disconnect and forward all telephone numbers, white and yellow page telephone references and advertisements, and all trade and similar name registrations and business licenses, and to cancel any interest which you may have in the same;

13.1.5. Upon our request, provide us with a complete list of your employees, customers and customer contacts and their respective addresses and any outstanding obligations you may have to any third parties;

13.1.6. Cease to use in any manner whatsoever, including in your business operations and advertising, any methods, procedures, technology or other component of the Franchised Business in which we have any right, title or interest. You agree that we or our designated agent may enter upon the Premises at any time to make such changes and take possession of such items at your sole risk and expense and without liability for trespass or compensation to you; and

13.1.7. Cease to use the Licensed Marks and any other marks and indicia of operation associated with the Franchised Business. Without limiting the generality of the foregoing, you agree that in the event of any termination or expiration of this Agreement, you will remove all signage bearing the Licensed Marks from the Premises and any vehicles used in the Franchised Business, and, upon our request, deliver the facia for such signs to us. You agree that we or a designated agent may enter upon the Premises at any time to make such changes at your sole risk and expense and without liability for trespass or compensation to you.

13.2. Our Right to Purchase Personal Property. Within thirty (30) days after the termination or expiration of this Agreement, but not upon an approved transfer, we shall have an option, but not an obligation, to buy, and you hereby agree to sell us, all of your right, title, and interest in any and all equipment, inventory, supplies and other personal property used in connection with the operation of your Franchised Business. The purchase price for any equipment, inventory, supplies and other personal property in like

new, resalable condition shall be the purchase price for such item being repurchased as published by us at the date of your original purchase of the equipment, inventory, supplies or other personal property that we are repurchasing, plus shipping, from us or our Affiliate. We shall be entitled to an offset from the purchase price for (i) any money owed by you to us and (ii) any payments necessary to acquire clear title to the property being repurchased.

14. INSURANCE

14.1. Lines of Insurance. You shall, at your expense and no later than upon commencement of the business contemplated by this Agreement, procure and maintain in full force and effect throughout the term of this Agreement the following lines of insurance which shall be in at least the following minimum amounts and shall designate us, including our Affiliates, Owners, officers, directors and employee, as an additional insured:

TYPE OF INSURANCE	CURRENT MINIMUM AMOUNT
Worker's Compensation	Statutory
Comprehensive General Liability (including Broad Form Contractual Broad Form Property Damage and Personal Injury)	Not less than $1,000,000 combined single limit
Excess/Umbrella Coverage	Not less than $2,000,000

14.2. Modification to Insurance Lines. Notwithstanding anything in this Agreement to the contrary, we reserve the right to add types of coverages and/or change the minimum coverages upon written notice to you and you agree to conform with such changes within thirty (30) days of being advised of the same.

14.3. Insurance Certificates. You shall make timely delivery of certificates and policies of all required insurance to us prior to the opening of the Franchised Business, each of which shall contain a statement by the insurer that the policy will not be cancelled or materially altered without at least thirty (30) days prior written notice to us.

14.4. No Relief from Indemnity Requirement. The procurement and maintenance of insurance shall not relieve you of any liability to us under any indemnity requirement of this Agreement.

15. TAXES, PERMITS AND INDEBTEDNESS

15.1. Taxes. You shall promptly pay when due any and all federal, state and local taxes including, without limitation, unemployment and sales taxes, levied or assessed with

5. Franchisee agrees, in the event it continues to operate or subsequently begins to operate any other business, not to use any reproduction, counterfeit, copy, or colorable imitation of the Proprietary Marks, either in connection with such other business or the promotion thereof, which is likely to cause confusion, mistake, or deception, or which is likely to dilute Franchisor's rights in and to the Proprietary Marks. Further, Franchisee agrees not to utilize any designation of origin or description or representation that falsely suggests or represents an association or connection with Franchisor constituting unfair competition.

6. Franchisee, in the event it continues to operate or subsequently begins to operate any other business, not to use any form of the Fetch! name for search engine optimization or any electronic media purposes.

B. Payment of Moneys Due

1. Franchisee shall promptly pay all sums owing to Franchisor and its subsidiaries and affiliates. In the event of termination for any default of Franchisee, such sums shall include all damages, costs, and expenses, including reasonable attorney's fees, incurred by Franchisor as a result of the default. This obligation shall give rise to and remain, until paid in full, a lien in favor of Franchisor against any and all of the personal property, furnishings, equipment, signs, fixtures, and inventory owned by Franchisee and located on the premises operated hereunder at the time of default.

2. Franchisee shall pay to Franchisor all damages, costs, and expenses, including reasonable attorney's fees, incurred by Franchisor subsequent to the termination or expiration of this Agreement in obtaining injunctive or other relief for the enforcement of any provisions of this Section XV.

C. Return of Brand Standards and Business Documents

Franchisee shall immediately deliver to Franchisor all documents, including the Brand Standards, records, files, instructions, correspondence, brochures, agreements, invoices, and any and all other materials relating to the operation of the Franchise in the Franchisee's possession, and all copies thereof (all of which are acknowledged to be Franchisor's property). Franchisee shall retain no copy or record of any of the foregoing, except Franchisee's copy of this Agreement and of any correspondence between the parties and any other documents which Franchisee reasonably needs for compliance with any provision of law.

D. Repurchase Option

Within fifteen (15) days from the date of termination or expiration, Franchisee and Franchisor shall arrange for an inventory to be made, at Franchisor's cost, of all personal property, fixtures, equipment, and inventory of Franchisee, including, without limitation, any and all items bearing the Proprietary Marks, related to the operation of the Franchise. Franchisor shall have the option, to be exercised within thirty (30) days after termination or expiration, to purchase from Franchisee any and all such items at fair market value. If the parties cannot agree on fair market value within a reasonable time, an independent appraiser shall be designated by Franchisor, and his determination shall be binding. If Franchisor elects to exercise any option to purchase herein provided, it shall have the right to set off all amounts due from Franchisee under this Agreement, and the cost of the appraisal, if any, against any payment therefor.

E. Covenants

Franchisee shall comply with the covenants contained in Section XVI of this Agreement.

F. Information and Future Business

Franchisee shall provide to Franchisor all Client Information and names and contact information of all employees and independent contractors involved in the business of the Franchise. Franchisor may itself, or may allow franchisees to, service clients or former clients of Franchisee, hire such employees, contract with such independent contractors and conduct the business previously conducted by Franchisee in the Target Area.

XVI. COVENANTS

A. Franchisee covenants that during the term of this Agreement, except as otherwise approved in writing by Franchisor, Franchisee (or, if Franchisee is a Legal Entity, a principal of Franchisee approved by Franchisor) shall devote full time, energy, and best efforts to the management and operation of the Franchise and other franchises established and operated by Franchisee under the System.

B. Franchisee specifically acknowledges that, pursuant to this Agreement, Franchisee will receive valuable specialized training and confidential information, including, without limitation, information regarding the operational, sales, promotional and marketing methods and techniques of Franchisor and the System. Franchisee covenants that, during the term of this Agreement, and for a continuous uninterrupted period commencing upon the expiration, termination, transfer or assignment of this Agreement, regardless of the cause for termination, and continuing for two (2) years thereafter, Franchisee shall not, except as otherwise approved in writing by Franchisor, either directly or indirectly, for itself, or through, on behalf of, or in conjunction with any person, persons, or legal entity:

1. Divert or attempt to divert any business or client of the Franchise to any competitor, by direct or indirect inducement or otherwise, or do or perform, directly or indirectly, any other act injurious or prejudicial to the goodwill associated with Franchisor's Proprietary Marks and the System, including, but not limited to, any effort or attempt to create a service or System that would compete with any of the Franchisor's services offered to new or existing franchisees such as the Sales & Marketing Center.

2. Employ or contract with, or seek to employ or contract with any officer, director, or other personnel of Franchisor or developer of Franchisor, or otherwise directly or indirectly induce such person to leave his or her employment or terminate his contract.

C. Franchisee covenants that Franchisee shall not, except as otherwise approved in writing by Franchisor, during the term of this Agreement and for a continuous uninterrupted period commencing upon the expiration, termination (regardless of the cause for termination), transfer or assignment of this Agreement, and continuing for two (2) years thereafter, either directly or indirectly for itself, or through, on behalf of, or in conjunction with any person, persons, or legal entity, own, maintain, operate, engage in, be employed by, or have any interest in any business which provides in home pet or home care and any other related services the Franchisor offers similar in scope to the services offered under the System and Proprietary Marks and which is, or is intended to be, operated within the Target Area or within a radius of twenty-five (25) miles around the Target Area or within a radius of twenty-five (25) miles around the Target Area of any other franchisee.

performance of all franchisees plus all other amounts and damages Franchisor could lawfully claim.

14. OBLIGATIONS UPON TERMINATION OR EXPIRATION

Upon termination or expiration of this Agreement, all rights granted hereunder to Franchisee shall forthwith terminate, and:

14.1. Cease Operations. Franchisee shall immediately cease to operate the Franchise, and shall not thereafter, directly or indirectly, represent to the public or hold itself out as a present or former franchisee of Franchisor.

14.2. Cease Use of Marks. Franchisee shall immediately and permanently cease to use, in any manner whatsoever, any confidential methods, procedures and techniques associated with the System, the mark "Wallaby Windows" and all other Marks and distinctive forms, slogans, signs, symbols, and devices associated with the System. In particular, Franchisee shall cease to use, without limitation, the Wallaby Vehicles, all signs, advertising materials, displays, stationery, forms, and any other articles that display the Marks.

14.3. Cancellation of Assumed Names. Franchisee shall take such action as may be necessary to cancel any assumed name or equivalent registration which contains the mark "Wallaby Windows" and all other Marks, and/or any other service mark or trademark of Franchisor, and Franchisee shall furnish Franchisor with evidence satisfactory to Franchisor of compliance with this obligation within five days after termination or expiration of this Agreement.

14.4. Assign Lease; Modification of Premises. Franchisor, or any affiliate of Franchisor, shall have the right and option, but not the obligation, in Franchisor's sole discretion, to acquire the Lease, or otherwise acquire the right to occupy the Franchise Location (if applicable). Franchisor may assign or delegate this right or option to any affiliate or designee of Franchisor, without notice to, or request for approval from, the landlord or lessor of the Franchise Location. If Franchisor or its assignee or delegatee does not elect or is unable to exercise any option it may have to acquire the Lease, or otherwise acquire the right to occupy the Franchise Location, Franchisee shall make such modifications or alterations to the Franchise Location operated hereunder immediately upon termination or expiration of this Agreement as may be necessary to distinguish the appearance of said premises from that of other Franchises, and shall make such specific additional changes thereto as Franchisor may reasonably request for that purpose. If Franchisee fails or refuses to comply with the requirements of this **Section 14.4**, Franchisor (or its designee) shall have the right to enter upon the premises of the Franchise, without being guilty of trespass or any other tort, for the purpose of making or causing to be made such changes as may be required, at the expense of Franchisee, which expense Franchisee agrees to pay upon demand.

14.5. Telephone, Etc. Franchisee shall cease use of, and if Franchisor requests, shall transfer to Franchisor, all telephone numbers, customer lists, and any

domain names, websites, email addresses, and any other identifiers, whether or not authorized by Franchisor, used by Franchisee while operating the Franchise.

14.6. No Confusion. Franchisee agrees, if it continues to operate or subsequently begins to operate any other business, not to use any reproduction, counterfeit copy, or colorable imitation of the Marks, either in connection with such other business or the promotion thereof, which is likely to cause confusion, mistake, or deception, or which is likely to dilute Franchisor's rights in and to the Marks, and further agrees not to utilize any designation of origin, description, trademark, service mark, or representation which suggests or represents a present or past association or connection with Franchisor, the System, or the Marks.

14.7. Pay Monies Owed. Franchisee shall promptly pay all sums owing to Franchisor and its subsidiaries and affiliates (regardless of whether those obligations arise under this Agreement or otherwise). In the event of termination for any default of Franchisee, such sums shall include all damages, costs, and expenses, including reasonable attorneys' fees, incurred by Franchisor as a result of the default.

14.8. Damages and Costs. Franchisee shall pay Franchisor all damages, costs, and expenses, including reasonable attorneys' fees, incurred by Franchisor subsequent to the termination or expiration of this Agreement in obtaining injunctive or other relief for the enforcement of any provisions of this **Section 14**.

14.9. Return of Manuals. Franchisee shall immediately deliver to Franchisor the Manuals and all other manuals, records, and instructions containing confidential information (including without limitation any copies thereof, even if such copies were made in violation of this Agreement), all of which are acknowledged to be the property of Franchisor.

14.10. Option to Purchase Furnishings and Equipment. Franchisor shall have the option to purchase from Franchisee any or all of the Wallaby Vehicles and other vehicles, furnishings, equipment, signs, fixtures, supplies, or inventory of Franchisee related to the operation of the Franchise, at the lesser of the fair market value or Franchisee's book value. Franchisor shall have 30 days from the expiration or termination of this Agreement to notify Franchisee that Franchisor will exercise its option under this Section 14.10, and another 60 days from such notice to complete such purchase. The book value of any such item shall be determined based upon a five-year straight-line depreciation of original costs. (each year or portion of a year shall decrease value by 20%) For equipment that is five or more years old, the parties agree that fair market value shall be deemed to be 10% of the equipment's original cost. If Franchisor elects to exercise any option to purchase herein provided, it shall have the right to set off all amounts due from Franchisee as well as all amounts due to Franchisor's affiliates from Franchisee. Franchisee shall take all actions as necessary to ensure that any items purchased by Franchisor shall be free of all liens or other encumbrances at the time Franchisee sells such items to Franchisor. Items purchased hereunder shall be delivered, at Franchisee's expense, to the location reasonably specified by

Franchisor or Franchisor's principal place of business. Book value as defined above shall be decreased by the amounts necessary to return the equipment or vehicles to a resalable condition (i.e. cost of replacing graphics, worn, broken or missing parts or goods). Franchisor shall inspect the items within 3 business days after they are delivered to Franchisor and shall notify Franchisee of all additional deductions and costs necessary to comply with the above.

14.11. Right to Enter and Operate. In order to preserve the goodwill of the System following termination, Franchisor (or its designee) shall have the right to enter the Franchise Location (if applicable) (without liability to Franchisee, Franchisee's Principals, or otherwise) or to take possession of the Wallaby Vehicle(s) used by Franchisee for the purpose of continuing the Franchise's operation and maintaining the goodwill of the business.

14.12. Close Vendor Accounts. Franchisee must close all accounts with vendors which were opened in connection with the opening and operation of the Franchise. Franchisor has the right to notify Franchisee's vendors that this Agreement has expired or been terminated and to require them to close Franchisee's accounts, if Franchisee fails to do so.

14.13. Security Interest. For the purpose of securing its obligations under this Agreement, Franchisee hereby grants Franchisor a security interest in all personal property related to the operation of the Franchise of any nature now owned or hereinafter acquired by Franchisee, including, but not limited to, all signs, logos bearing any of the Marks, inventory, equipment, Wallaby Vehicles(s), trade fixtures, furnishings and accounts, together with the proceeds therefrom (the **"Security Agreement"**). Any event of default by Franchisee under this Agreement shall be deemed a breach of the Security Agreement. Franchisee covenants to execute and deliver to Franchisor any and all instruments Franchisor may reasonably request from time to time in order to perfect the security interest granted herein, including, without limitation, the appropriate UCC-1 Financing Statements.

15. COVENANTS

15.1. Full Time and Best Efforts. Franchisee covenants that during the term of this Agreement, except as otherwise approved in writing by Franchisor, Franchisee (or its Operating Principal if Franchisee is an entity) (or a Manager who will assume primary responsibility for the franchise operations and shall have been previously approved in writing by Franchisor) and a Salesperson shall devote full time, energy, and best efforts to the management and operation of the Franchise.

15.2. In-Term Covenants. Franchisee specifically acknowledges that, pursuant to this Agreement, Franchisee will receive valuable specialized training and confidential information, including, without limitation, information regarding the operational, sales, promotional, and marketing methods and techniques of Franchisor and the System. Franchisee covenants that during the term of this Agreement, except as otherwise approved in writing by Franchisor, Franchisee

(5) Franchisee signs EA's then-current form of Franchise Agreement (the "Successor Franchise Agreement"), which may be materially different from this Agreement (including, without limitation, higher and/or different fees), except that (i) Franchise will not be required to pay another initial franchise fee, receive another renewal or successor term, nor be required to complete initial training; and (ii) EA shall not be required to perform any of the pre-opening obligations set forth in such Successor Franchise Agreement;

(6) Franchisee pays a renewal fee of five thousand dollars ($5,000), which shall replace any initial franchise fee required by EA at the time of renewal;

(7) Franchisee has complied with EA's then-current qualification and training requirements and pays all then-applicable training fees; and

(8) Franchisee has executed a general release, in a form prescribed by EA, of any and all claims against EA and its parent companies, subsidiaries and other affiliates and all of their respective owners, officers, directors, agents, and employees.

C. Non-Renewal. If Franchisee fails to timely exercise its renewal right or does not deliver to EA all items required for renewal, including the executed Successor Franchise Agreement, the executed Release and renewal fee, within 10 days after EA delivers such documents to Franchisee for execution, then Franchisee will be deemed to have declined to renew its rights to the Franchised Business, and Franchisee's right to renew will expire automatically at the end of the Term.

D. Effect of Non-Renewal or Expiration. Non-renewal or expiration of this Agreement will end the Agreement and Franchisee's right to operate the Franchised Business. Upon non-renewal or expiration of this Agreement, Franchisee must meet all obligations applicable upon termination or expiration, as set forth in Section 19. Notwithstanding the foregoing, at its option, EA may extend Term for the time period necessary to give Franchisee reasonable time to satisfy the conditions to renewal set forth in Section 2.B.

3. DEVELOPMENT AND OPENING

A. Site Selection.

(1) Franchisee's Obligations.

(a) Within one-hundred and twenty (120) days after the Effective Date, Franchisee shall secure (either through purchase or lease) real estate for the Store Location ("Site Selection Deadline"). Any lease for the Store Location shall be in writing and submitted to EA for acceptance in accordance with Section 3.A.(2) of this Agreement. The Store Location and any applicable lease shall:

(i) be suitable for the preparation and sale of all products EA requires and authorizes EDIBLE® Businesses to offer and sell;

(ii) provide for Franchisee's occupancy of and operation of the Franchised Business from the Store Location, at all times during the Term;

C. **Prohibition on Franchisee Withholding Payments.** Franchisee agrees that it will not withhold payment of any amounts owed to EA on the grounds of EA's alleged nonperformance of any of its obligations under this Agreement or for any other reason. EA may set off any amounts that Franchisee or its owners or affiliates owe EA, EA's affiliates, or others (whether under this Agreement or another agreement) against any amounts that EA or its affiliates owe Franchisee or its owners or affiliates (whether under this Agreement or otherwise). Franchisee specifically waives any right it may have at law or in equity to set off any funds or to fail or refuse to perform any of its obligations under this Agreement. Franchisee agrees to submit all claims, unless otherwise resolved by the parties' mutual agreement, pursuant to provisions of Section 20 below.

D. **General Provisions Concerning Default and Termination.** In any arbitration or other proceeding in which the validity of EAs termination of this Agreement or refusal to enter into a successor franchise agreement is contested, EA may cite to and rely upon all defaults or violations of this Agreement, not only the defaults or violations referenced in any written notice. Franchisee agrees that EA has the right and authority (but not the obligation) to notify any lender and any or all of Franchisee's owners, landlords, creditors, and/or suppliers if Franchisee is in default under, or EA has terminated, this Agreement.

19. FRANCHISEE'S OBLIGATIONS UPON TERMINATION OR EXPIRATION

A. **Effect of Termination or Expiration.** Upon termination or expiration of this Agreement, all rights granted to Franchisee under this Agreement shall immediately terminate including the license to use the Marks and Franchisee's right to operate the Franchised Business. Notwithstanding the foregoing, the following provisions shall survive the termination or expiration of this Agreement: Section 4.F., Section 8, Section 11.A.(2), Section 14, Section 15, Section 19, Section 20, Section 21, and Section 22.

B. **Cease Operating.** Upon termination or expiration of this Agreement, Franchisee shall immediately cease operating the Franchised Business and cease using any of the Marks and Confidential Information; provided however, that this Section 19.B. shall not apply to the operation by Franchisee of any other franchises under the System that EA may separately and independently have granted to Franchisee and that EA has not terminated.

C. **Modify the Premises.** If EA does not exercise its option to acquire the Franchised business at the Store Location pursuant to this Section 19, Franchisee shall make such modifications to the premises of the Franchised Business immediately upon termination or expiration of this Franchise Agreement as may be necessary to distinguish the appearance of the premises from that of other Edible® Businesses, and Franchisee shall make such specific additional modifications as EA may reasonably request for that purpose. If Franchisee fails to comply with the requirements of this Section 19, EA shall have the right to enter upon the Store Location without being guilty of trespass or any other tort to make such modifications, at Franchisee's expense, which Franchisee shall pay upon demand.

D. **Immediate Payment.** Upon termination or expiration of this Agreement, Franchisee shall immediately pay all sums owing to EA, its affiliates, and its approved or designated suppliers, through the effective date of termination or expiration.

E. **Liquidated Damages.** If this Agreement is terminated pursuant to Section 18, EA shall be entitled, as liquidated damages and not as a penalty and solely to compensate EA for damages due to

Exhibit A-Examples of Termination Provisions

Franchisee's failure to continue operating the Franchised Business for the remainder of the Term, to a sum equal to:

(1) $15,000 to cover the administrative costs associated with the store closure; and,

(2) the average Royalties and Marketing Fees Cap owed by Franchisee (even if not paid) per month over the 12-month period preceding the date of termination (or, if the Franchised Business was not open throughout such 12-month period, then the average Royalties and Marketing Fees Cap earned per month for the period in which the Franchised Business was open), multiplied by the lesser of: (i) 18; or (ii) the number of months remaining in the Term.

This liquidated damages provision will not limit EA's right to injunctive relief relating to any violations of this Agreement, nor limit any damages available to EA arising out of such violations. Franchisee acknowledges and agrees that the amount of liquidated damages determined in accordance with the preceding formula reasonably represents EA's monetary losses resulting from the termination of this Agreement.

F. Return of Materials. Franchisee agrees, at its own cost and without any payment from EA, to return to EA, to make available to EA for pick-up, or to destroy (at EA's option), in any case within seven (7) days of termination or expiration of this Agreement, all signs, sign-faces, sign-cabinets, menu boards, marketing materials, forms, all copies of the Manuals, Confidential Information and any and all other materials provided by EA to Franchisee or created by a third party for Franchisee relating to the operation of the Franchised Business, and all items containing any Marks ("Proprietary Materials"); provided however, that Franchisee may retain Franchisee's copy of this Franchise Agreement, and correspondence between Franchisee and EA, and any other document which Franchisee needs for compliance with any applicable laws. Franchisee shall delete from the Computer System any proprietary information, including but not limited to products, methods of preparation, inventory and pricing. In the event that Franchisee fails to comply with this obligation, EA has the right to perform such obligations on Franchisee's behalf and at Franchisee's sole expense, including by contacting any vendor that services the Computer System to disable Franchisee's access and/or by physically seizing control and possession of the Computer System to perform such obligations on Franchisee's behalf. Franchisee is obligated to pay EA fifteen thousand dollars ($15,000) for all Confidential Information and Proprietary Materials not returned to EA when required.

G. Return of Proprietary Equipment. Franchisee agrees, at its own cost and without any payment from EA, to return to EA or to make available to EA for pick-up (at EA's option) within seven (7) days of termination or expiration of this Agreement the Proprietary Equipment. If Franchisee fails to do so voluntarily when EA requires, EA or its representatives may enter the Store Location at EA's convenience and remove these items without liability to Franchisee or third parties. Franchisee must reimburse EA's costs of doing so. Franchisee is obligated to pay EA fifteen thousand dollars ($15,000) for each piece of Proprietary Equipment not returned to EA when required.

H. Close Vendor Accounts. Franchisee must close all of Franchisee's accounts with suppliers which were opened in connection with the Franchised Business. EA has the right to notify Franchisee's suppliers that this Agreement has expired or been terminated and to require them to close Franchisee's accounts, if Franchisee fails to do so.

I. **Cease Identification with EA.** Upon termination or expiration of this Agreement, Franchisee may not directly or indirectly at any time or in any manner identify itself in any business as a current or former EDIBLE® Business or as one of EA's current or former franchisees; use any Mark, any colorable imitation of a Mark, or other indicia of an EDIBLE® Business in any manner or for any purpose; or use for any purpose any trade name, trade or service mark, or other commercial symbol that indicates or suggests a connection or association with EA. Franchisee shall promptly cancel all assumed name or equivalent registrations relating to Franchisee's use of the Marks and notify any applicable telephone, Internet, email, electronic network, directory, and listing entities of the termination or expiration of Franchisee's right to use any numbers, addresses, domain names, locators, directories and listings associated with any of the Marks; provided however, that this Section 19.I. shall not apply to the operation by Franchisee of any other franchisee under the System that EA may separately and independently have granted Franchisee and that EA has not terminated. Franchisee will authorize the transfer of the foregoing to EA or any new franchisee as may be directed by EA. Franchisee hereby irrevocably appoints EA, with full power of substitution, as Franchisee's true and lawful attorney-in-fact, which appointment is coupled with an interest; to execute such directions and authorizations as may be necessary or appropriate to accomplish the foregoing.

J. **Evidence of Compliance.** Franchisee agrees to give EA evidence satisfactory to EA of Franchisee's compliance with these obligations.

K. **EA's Purchase and Lease Rights.** Upon the termination or expiration of this Agreement. EA shall have the right, but not the obligation, pursuant to this Section 19.K., to purchase the Franchised Business and/or the assets of the Franchised Business and/or lease the premises of the Franchised Business, or to assign this right to any party of EA's choosing, at its election (the "Purchase Option").

(1) Time to Exercise. EA or its designee to whom EA has assigned the Purchase Option, may exercise the Purchase Option by giving Franchisee written notice no later than thirty (30) days after the date of termination or expiration, of its intent either:

(a) to purchase the assets of the Franchised Business and/or the fee simple interest in the premises of the Store Location (if Franchisee or one of its affiliates owns such premises) or,

(b) if Franchisee (or one of its affiliates) does not own the premises or EA chooses not to purchase Franchisee's (or its affiliate's) fee simple interest in the premises, to purchase the assets of the Franchised Business and/or exercise its rights to the premises pursuant to subparagraph (3) below.

(2) Representations and Warranties. EA is entitled to all customary warranties and representations in its asset purchase, including, without limitation, representations and warranties as to ownership and condition of and title to assets; liens and encumbrances on assets; validity of contracts and agreements; liabilities affecting the assets, contingent or otherwise; and indemnities for all actions, events, and conditions that existed or occurred in connection with the Franchised Business before the closing of EA's purchase.

(3) Right to Premises. If Franchisee leases the premises for its Store Location from an unaffiliated lessor, or if EA chooses not to purchase Franchisee's (or its affiliate's) fee simple interest in the premises, Franchisee agrees (as applicable) at EA's election:

(a) to assign its leasehold interest in the premises to EA;

(b) to enter into a sublease for the remainder of the lease term on the same terms (including renewal options) as the lease; or

(c) to lease the premises to EA for an initial five (5) year term, with two five (5) year renewal terms (at EA's option), on commercially reasonable terms. If the parties cannot agree on such lease terms, the dispute will be resolved using the Appraisal method set forth in Section 19.K.(5) below.

(4) Purchase Price. The purchase price for the assets of the Franchised Business and, if applicable, the fee simple interest in the premises will be their fair market value, provided that these items will not include any value for:

(a) the Franchise or any rights granted by this Agreement;

(b) goodwill attributable to the Marks and EA's brand image and other intellectual property;

(c) participation in the network of EDIBLE® Businesses; or

(d) any Proprietary Materials or Proprietary Equipment.

EA may exclude from the assets purchased any Operating Assets or other items that are not reasonably necessary (in function or quality) to the operation of the Franchised Business or that EA has not approved as meeting System Standards for EDIBLE® Businesses, and the purchase price will reflect these exclusions.

(5) Appraisal. If EA and Franchisee cannot agree on fair market value or rental value, fair market value or rental value will be determined by one (1) independent accredited appraiser upon whom EA and Franchisee agree who will conduct an appraisal or rental determination and, in doing so, be bound by the criteria specified in subparagraph (3). Franchisee and EA agree to select the appraiser within fifteen (15) days after EA (or its assignee) notifies Franchisee that it wishes to exercise its Purchase Option (if Franchisee and EA have not agreed on fair market value before then). Franchisee and EA will share equally the appraiser's fees and expenses. The appraiser must complete its appraisal or rental determination within thirty (30) days after its appointment. The purchase price will be the appraiser's appraised value, as applicable. The rental rate will be the appraiser's rental determination, as applicable. If EA and Franchisee cannot mutually agree upon one appraiser within in fifteen (15) days of EA (or its assignee) notifying Franchisee that it wishes to exercise its purchase option, then EA, within seven (7) days thereafter, shall notify Franchisee of the names of two appraisers or firms having the capacity to perform or engage others to appraise the premises or fair market rent for the premises. Franchisee shall select, within seven (7) days after such notification by EA, one of such appraisers or firms to be responsible for determining fair market purchase price or rent value; otherwise, EA shall select one such appraiser or firm to be responsible for determining fair market value or rental value and such appraiser's or

firm's decision shall be binding. EA and Franchisee shall divide equally the cost of any appraiser or firm.

(6) Closing. EA (or its assignee) will pay the purchase price at the closing, which will take place not later than sixty (60) days after the purchase price is determined, although EA (or its assignee) may decide after the purchase price is determined not to purchase the Franchised Business and/or the fee simple interest in the premises. EA may set off against the purchase price, and reduce the purchase price by, any and all amounts Franchisee or its owners owe EA, EA's affiliates, or others on account of Franchisee's operation of the Franchised Business. At the closing, Franchisee agrees to deliver instruments transferring to EA (or its assignee):

(a) good and merchantable title to the assets purchased, free and clear of all liens and encumbrances (other than liens and security interests acceptable to EA), with all sales and other transfer taxes paid by Franchisee;

(b) all of the licenses and permits of the Franchised Business that may be assigned or transferred; and

(c) the fee simple or leasehold interest in the premises and improvements or a lease assignment or lease or sublease, as applicable.

If Franchisee cannot deliver clear title to all of the purchased assets, or if there are other unresolved issues, EA (or its assignee) and Franchisee will close the sale through an escrow. Franchisee and its owners further agree to execute general releases, in a form satisfactory to EA, of any and all claims against EA and its owners, affiliates, officers, directors, employees, agents, successors, and assigns. If EA exercises its rights under this Section 19.K., Franchisee and its owners agree that, for two (2) years beginning on the closing date, they will be bound by the non-competition covenant contained in Section 15.C.

(7) Prohibition on Asset Sales by Franchisee. Franchisee may not under any circumstances sell any of the assets of its former Franchised Business until EA has exercised or elected not to exercise its right to purchase those assets, as provided in this Section 19.K. However, under no circumstances may Franchisee sell any items containing any Mark, any Confidential Information, any Proprietary Materials, or any Proprietary Equipment.

20. DISPUTE RESOLUTION

A. **Notice and Opportunity to Cure.** As a mandatory condition precedent prior to Franchisee's taking any legal or other action against EA, whether for damages, injunctive, equitable, or other relief (including, but not limited to, relief related to termination or the remedy of rescission), Franchisee shall first give EA ninety (90) days' prior written notice and opportunity to cure any alleged act or omission, or to resolve any dispute.

B. **Mediation.** If a dispute arises out of or relates to this Franchise Agreement, or the breach thereof, the Parties agree first to try in good faith to settle the dispute by mediation using the American Arbitration Association ("AAA") or another mutually agreeable mediation service or mediator, with the mediation to be conducted at a suitable location which is within ten (10) miles of where EA has its principal business address at the time the dispute

6.7.3. As to any products furnished by Franchisor to Franchisee manufactured in accordance with drawings, designs or specifications proposed or furnished by Franchisee, or any claim of contributory infringement resulting from the use or resale by Franchisee of products sold hereunder, Franchisor shall not be liable, and Franchisee shall indemnify Franchisor and hold Franchisor harmless from and against any and all loss, liability, damage, claim or expense (including but not limited to Franchisor's reasonable attorneys' fees and other costs of defense) incurred by Franchisor as a result of any claim of patent, trademark, copyright or trade secret infringements, or infringements of any other proprietary rights of third parties.

7. STANDARDS OF OPERATION

7.1. Franchised Business Opening. Subject to Section 7.2, below, you agree to open your Franchised Business within ninety (90) days of the Effective Date, unless we agree in writing to a longer period of time.

7.2. Open only upon Authorization. Your Franchised Business shall be opened for business only after receipt of authorization to do so by us.

7.3. Training. Prior to opening your Franchised Business, up to two of your key employees designated by us, usually the owner of the Franchisee or the Franchisee's manager, shall have completed our applicable training programs to our satisfaction. Such training shall be held at our headquarters or at another location designated by us. Replacement personnel shall likewise complete such applicable training programs to our satisfaction promptly after they are hired by you. You shall pay our then-applicable training fee for the training of all replacement personnel and you shall be responsible for all your expenses relating to training of initial key personnel and other personnel, including replacement personnel, such as room, board, travel and salary expense.

7.4. Supervision. Your Franchised Business shall be under your full-time supervision, or that of your Franchised Business manager. Either party shall have completed our applicable training programs and shall be responsible for the business operations of your Franchised Business.

7.5. Operation of your Franchised Business. You agree to comply with all of our Franchised Business rules, regulations, policies and standards which are by their terms mandatory including, without limitation, those contained in the Operations Manuals. You shall operate and maintain your Franchised Business solely in the manner and pursuant to the standards prescribed herein, in the Operations Manuals or in other written materials provided by us to you from time to time and shall make such modifications in the operation of the Franchised Business as we may require to ensure that our required degree of quality, service and image is maintained and shall refrain from deviating therefrom and from otherwise operating in any manner which adversely reflects on our name and goodwill or on the Licensed Marks. Without limiting the generality of the foregoing, you specifically agree as follows:

7.5.1. To purchase, install and use, at your expense, all equipment and signage, all as may be required by us from time to time and to refrain from purchasing, installing or using on any such item not meeting our standards and specifications. Notwithstanding anything in this Section to the contrary, you shall replace all signs within one (1) week of receiving notice to do so from us.

7.5.2. To maintain in sufficient supply, and use at all times, only operating products, materials, supplies and expendables, as conform with our then-current standards and specifications and to refrain from using non-conforming items without our prior consent.

7.5.3. To sell and to offer for sale (a) all such services and products as we may from time to time require, and (b) only those services and products which we may from time to time approve, which are not subsequently disapproved as not meeting our then current quality standards and specifications or otherwise removed by us from our list of approved services and products.

7.5.4. To use such standardized accounting forms, reporting forms and other forms as may be developed from time to time by us and to file such forms with us in a timely manner as may be required by us.

7.5.5. To record all revenue and maintain all business information and records associated with your Franchised Business using the reporting systems and associated equipment specified by us in the Operations Manuals and to maintain, without alteration, all information and categories required by us to be programmed into the revenue reporting system unless we provide prior written approval or instructions to you to alter such categories. You hereby authorize us to access all information from such reporting systems and associated equipment whether by inspection on the Premises or via retrieval by modem or other method of retrieval, as we, in our sole discretion, deem necessary. Any electronic reporting systems and associated equipment shall be accessible to us 24 hours per day, during every day of the year, including Sundays and holidays, for electronic access. Paper records and other non-electronic data shall be accessible during normal business hours for personal access, and you agree not to inhibit our access to electronic reporting system, associated equipment, paper records and other non-electronic data.

7.5.6. To maintain a competent, conscientious and trained staff and take all necessary steps to ensure that your employees preserve good customer relations, render prompt and courteous services and are knowledgeable about the services and products. You are solely responsible for all employment decisions of your Franchised Business, including hiring, firing, training, promotion, wage and hour requirements, recordkeeping, supervision and discipline of employees.

7.6 Purchases.

7.20. Covenants and Agreements to be Signed by Other Employees. Franchisor shall have the right to require Franchisee's employees that are involved in operating the Franchised Business, all personnel receiving special training from Franchisor and or having access to Confidential Information and any holder of a beneficial interest in Franchisee to execute covenants regarding non-competition and or confidentiality in a form prescribed or suggested by Franchisor.

8. OPERATIONS MANUALS

8.1. Compliance with Operations Manuals. In order to protect the reputation and goodwill of the businesses operating under the System and to maintain standards of operation under the Licensed Marks, you shall conduct your Franchised Business in accordance with various written instructions, including technical bulletins and confidential manuals (hereinafter and previously referred to collectively as the "Operations Manuals"), including such amendments thereto, as we may publish from time to time, all of which you acknowledge belong solely to us and shall be on loan from us to you during the term of this Agreement. When any provision in this Agreement requires that you comply with any of our standards, specifications or requirements, unless otherwise indicated, such standards, specifications or requirements shall be such as are set forth in this Agreement or as may, from time to time, be set forth by us in the Operations Manuals.

8.2. Revisions. You understand and acknowledge that we may, from time to time, revise the contents of the Operations Manuals to implement new or different requirements for the operation of your Franchised Business, and you expressly agree to comply with all such changed requirements which are by their terms mandatory, provided that such requirements shall also be applied in a reasonably nondiscriminatory manner to comparable businesses operated under the System by other SMART TIRES USA franchisees. The implementation of such requirements may require the expenditure of reasonable sums of money by you.

8.3. Master Copy Controls. You shall at all times ensure that your copy of the Operations Manuals is kept current and up to date. In the event of any dispute as to the contents thereof, the terms and dates of the master copy thereof maintained by us at our principal place of business shall be controlling.

8.4. Replacement Fee. If you lose any portion of the Operations Manuals, you must pay us a fee of $250, plus all shipping expenses, or such lesser amount as we may charge in our sole and absolute discretion. If the loss, in our opinion, is attributable to your breach of the Agreement we may also elect to terminate the Agreement.

9. ADVERTISING AND MARKETING

9.1. National Management and Advertising Fund. We or our designee shall

Standards"), as more fully described in Section VIII hereof. Franchisee shall also have access to the Brand Standards via the intranet.

E. Inspections

Franchisor shall seek to maintain the highest standards of quality, appearance, professionalism, reliability and service of the System, and to that end shall conduct, as it deems advisable, inspections of the Franchise, and evaluations of the services rendered and the products sold in connection therewith. Such inspections and evaluations may include secret shopper surveys, communications with clients and other means determined by Franchisor in its discretion.

As a means to gauge the above standards, Franchisor may require Franchisee to utilize a client feedback platform as specified by Franchisor. Franchisee understands such platform may extract and make available to Franchisor information about Franchisee's clients. Franchisee understands there may be a monthly charge for such platform. Both Franchisee and Franchisor shall have access to survey results, which Franchisor may use to take remedial action with Franchisee and for other purposes, if necessary or advisable.

F. Business Assessment

Franchisor shall offer to Franchisee, at no additional charge, one-on-one business coaching sessions to assist Franchisee in the development and operation of the Franchise.

IV. DUTIES OF FRANCHISEE

Franchisee understands and acknowledges that every detail of the Franchise is important to Franchisee, Franchisor, and other franchisees in order to maintain high and uniform operating standards, to increase the demand for the products and services sold by Franchisor and all franchisees, and to protect Franchisor's reputation and goodwill. Toward that end, Franchisee acknowledges and accepts the following duties:

A. Training

Franchisee shall attend and successfully complete all of Franchisor's required training programs as set forth in Section VI below. Franchisee will be solely responsible for training all non-managerial employees of Franchisee.

B. Cleanliness

Franchisee shall dress in accordance with Franchisor's standards, as set forth in the Brand Standards, at all times while conducting the business of the Franchise, and shall present a clean, neat appearance and render competent and courteous service to clients.

C. Service and Product Quality

1. Franchisee shall sell or offer for sale only such services and products as meet Franchisor's uniform standards of quality and as have been expressly approved for sale in writing by Franchisor. Franchisee shall provide services only in accordance with Franchisor's methods and techniques.

Franchisee shall refrain from any deviation from Franchisor's standards and specifications for the provision of services or the type or quality of products, without Franchisor's prior written consent. Franchisee shall discontinue selling or offering for sale such services or products as Franchisor may, in its discretion, disapprove in writing at any time.

2. Franchisee shall provide to Franchisor or its agents, at any reasonable time, samples of items without payment therefore, in amounts reasonably necessary for testing by Franchisor or an independent third party to determine whether said samples meet Franchisor's then current standards and specifications. Samples shall be provided to Franchisor prior to Franchisee publicly using or offering said items for sale. Franchisee shall bear the cost of such testing if the supplier of the item has not previously been approved by Franchisor, or if the sample fails to conform to Franchisor's specifications.

3. Franchisee shall have the right to offer and sell its services and products at any price Franchisee may determine and shall in no way be bound by any price which may be recommended or suggested by Franchisor.

D. Operation

1. Franchisee shall commence operation of the Franchise within thirty (30) days after successful completion of the next available initial training program.

2. Franchisee shall strictly comply with such mandatory methods, standards, and specifications as Franchisor may from time to time prescribe in the Brand Standards or otherwise in writing, to insure that the highest degree of quality, professionalism, reliability and service is uniformly maintained.

3. Notwithstanding any other provision of this Agreement, the methods, standards and specifications of Franchisor that Franchisee is required to follow (whether in the Brand Standards or otherwise) do not include any personnel policies or procedures. While the Franchisor by means of the Brand Standards or otherwise, may make available for Franchisee's optional use certain personnel policies and procedures, it is the Franchisee's decision to determine to what extent, if any, Franchisee will use any of such personnel policies and procedures.

4. Franchisee shall comply with all policies adopted by Franchisor from time to time, including but not limited to email and social media policies, in order to protect the business and reputation of Franchisor and its franchisees.

5. Franchisee agrees to maintain in sufficient supply and use at all times only such products, materials, supplies, and methods of service as conform to Franchisor's standards and specifications; and to refrain from deviating therefrom by using non conforming items or methods without Franchisor's prior written consent, which will not be unreasonably withheld.

6. Franchisee shall keep the Franchise open and in normal operation for such minimum hours and days as Franchisor may from time to time specify in the Brand Standards or as Franchisor may otherwise approve in writing, subject to local ordinances or restrictions, if any. Franchisee acknowledges and agrees that Franchisee or its designated assistant ("Assistant"), such as a general manager, must be able to respond to client and/or Sales & Marketing Center requests during normal business hours, and off business hours for emergencies.

7. Franchisee shall only affix signs, markings or other advertising to any vehicles used in the Franchise as provided by Franchisor. Franchisee shall submit to Franchisor any sample items for Franchisor's approval prior to affixing to any vehicles used in the Franchise.

8. Franchisee shall, at its own expense, comply with all applicable laws, ordinances, and regulations of municipal, county, state, or federal authority.

9. Franchisee shall, concurrent with the execution of this Agreement, engage the services of the Sales & Marketing Center.

E. Approved Equipment and Suppliers

Franchisor shall have the right to require that certain equipment, hardware, software, fixtures, furnishings, signs, supplies, other products and materials and services required for the operation of the Franchise be purchased and used by Franchisee and, in some cases, be purchased solely from suppliers (including manufacturers, distributors, other sources and us), who demonstrate to the continuing reasonable satisfaction of Franchisor the ability to meet Franchisor's then current standards and specifications for such items; who possess adequate quality controls and capacity to supply Franchisee's needs promptly and reliably; and who have first been approved in writing by Franchisor and not thereafter disapproved. If Franchisee desires to purchase items, other than Core Products (as defined in the Brand Standards), from an unapproved supplier, Franchisee shall submit to Franchisor a written request for such approval, which approval Franchisor shall not unreasonably withhold, and have such supplier acknowledge in writing that Franchisee is an independent entity from Franchisor and that Franchisor is not liable for debts incurred by Franchisee. Franchisor encourages Franchisee to submit requests for approval of new suppliers where Franchisee believes it could improve the System. Franchisor shall have the right to require that its representatives be permitted to inspect the supplier's facilities, and that samples from the supplier be delivered, at Franchisor's option, either to Franchisor or to an independent third party designated by Franchisor for testing. A charge not to exceed the reasonable cost of the inspection and the actual cost of the test shall be paid by Franchisee of the supplier. Franchisor may also require that the supplier comply with such other reasonable requirements as Franchisor may deem appropriate, including payment of reasonable continuing inspection fees and administrative costs. Franchisor reserves the right, at its option, to re-inspect the facilities, products and services of any such approved supplier and to revoke its approval upon the supplier's failure to continue to meet any of Franchisor's then current criteria. Franchisor makes no warranty on any items purchased or leased by Franchisee from any third-party source, regardless of any approval by Franchisor.

Franchisor shall have the right to require Franchisee to update computer software and hardware at any time in Franchisor's sole discretion. Franchisee may incur additional costs associated with these required updates.

F. Inspections

Franchisee shall grant Franchisor and its agents the right, at any reasonable time to enter upon the Franchise premises and to accompany Franchisee or Franchisee's employees or agents on any service call to a client's home or Franchise, to inspect, photograph, or videotape the Franchise and Franchise operations therein to insure compliance with all requirements of this Agreement. Franchisee shall cooperate with Franchisor's representatives in such inspections by rendering such assistance as they may reasonably

request. Upon reasonable notice from Franchisor, and without limiting Franchisor's other rights under this Agreement, Franchisee shall take such steps as may be necessary to correct immediately the deficiencies detected during any such inspection, including, without limitation, immediately desisting from the further use of any equipment, advertising materials, products; or supplies that do not conform with Franchisor's then-current specifications, standards, or requirements.

G. Harmful Business Practices Prohibited; Non-Disparagement

Franchisee shall not engage in any trade practice or other activity which is harmful to the goodwill or reflects unfavorably on the reputation of Franchisee or Franchisor, the Franchise, or the services and products sold in connection therewith, or which constitutes deceptive or unfair competition, consumer fraud or misrepresentation or otherwise is in violation of any applicable laws. Franchisee shall not at any time make, publish or communicate to any person or entity or in any public forum in any manner, whether by publication, mail, email, Internet postings or otherwise any defamatory or disparaging remarks, comments, or statements concerning Franchisor or its business or any of its officers, directors or employees now or in the future; provided, however, that nothing in this Agreement is intended to restrict Franchisee from communicating with Franchisor and/or other franchisees in a good faith effort to improve the System.

H. Corporate, Limited Liability or Partnership Franchisees

1. If Franchisee is a Legal Entity, it shall comply, except as otherwise approved in writing by Franchisor, with the following requirements throughout the term of this Agreement:

2. Franchisee shall furnish Franchisor with its Articles of Incorporation, Bylaws, Operating Agreement, Partnership Agreement or the like and other documents Franchisor may reasonably request, and any amendments thereto.

3. Franchisee shall confine its activities to operating the Franchise, and its governing documents shall at all times provide that its activities are confined exclusively thereto.

4. Franchisee shall maintain stop transfer instructions against the transfer on its records of any equity securities, membership interests, partnership interests or the like and shall issue no securities, membership interests or partnership interests upon the face of which the following printed legend does not legibly and conspicuously appear:

> The transfer of this _____ is subject to the terms and conditions of a Franchise Agreement with Fetch! Pet Care, Inc. Dated _____.
>
> Reference is made to the provisions of the said Franchise Agreement and to the _____ of this _____.

5. Franchisee shall maintain a current list of all owners of record and all beneficial owners of any class of voting stock, membership interests, partnership interests or the like of Franchisee and shall furnish the list to Franchisor upon request.

6. All of the shareholders, partners and members of, and all holders of beneficial interests in, the Franchisee, and the spouses of each of the foregoing, and the officers and directors of the

Franchisee, shall sign a guaranty of the Franchisee's obligations to Franchisor in the form of Schedule F attached to this Agreement.

I. Franchise Owner Summit

1. Franchisor may, in its discretion, hold meetings of Fetch! Pet Care franchisees ("Franchise Owner Summits") at locations designated by Franchisor for team-building, training, idea exchanges, and any other purposes determined by Franchisor. Franchisee or a principal of Franchisee shall attend each Franchise Owner Summit or, if there is more than one Franchise Owner Summit in the same calendar year, shall attend at least one Franchise Owner Summit during that calendar year.

2. Franchisee shall pay Franchisor the Franchise Owner Summit Attendance Fee for each person who attends the Franchise Owner Summit on behalf of Franchisee. Even if neither Franchisee nor a principal of Franchisee attend the required Franchise Owner Summit, Franchisee will be required to pay to Franchisor the Franchise Owner Summit Attendance Fee for one attendee.

3. The Franchise Owner Summit Attendance Fee will not exceed $500 per attendee. Other costs not covered by the Franchise Summit Attendance Fee (such as room, board and travel) are additional costs and will be borne solely by Franchisee.

V. FEES

A. Initial Fees

Franchisee, for its initial term, shall pay to Franchisor fees in the amounts set forth on Schedule C to this Agreement. Schedule C shall set forth the amount of the Franchise Fee (the "Initial Fees") and the due dates associated with such payments. An individual shall be required to personally guarantee the Promissory Note in the event the Franchisor is a legal entity. The Initial Fees shall be deemed fully earned and non refundable in consideration of administrative and other expenses incurred by Franchisor in granting this Franchise and for Franchisor's lost or deferred opportunity to Franchise others. For fees for renewal terms, see Section II.B.6.

Upon the satisfaction of certain conditions, and satisfying other key operational and performance indicators in Franchisor's sole discretion, Franchisee may be eligible to purchase one or more additional Target Areas during the term of this Agreement.

a. If Franchisee is approved to purchase such additional Target Areas the following fees in the amounts as set forth on Schedule C will be due at the time of purchase.

b. If Franchisee elects to purchase an additional Target Area of up to fifty thousand (50,000) households during its operation of the Franchise, then Franchisee will be required to meet Franchisor's then-current criteria for such purchase, including, without limitation, Franchisee being in good standing under this Agreement and the Target Area Franchisee wishes to purchase must be available. The Franchisee shall be required to enter into a separate franchise agreement in the then-current form of franchise agreement for each additional Target Area. In Franchisor's discretion, the additional Target Area must be contiguous to Franchisee's existing Target Area.

B. Compliance with System. Franchisee acknowledges and agrees that every detail of the Franchised Business, including without limitation the uniformity of appearance, service, products and advertising of the Franchised Business is important to Franchisee, EA, the System and EA's other franchisees, in order to maintain the System's high and uniform operating standards, to increase demand for the products and services, and to protect EA's reputation and goodwill. Franchisee must operate the Franchised Business in conformity with the System Standards. Pursuant to this ongoing responsibility, Franchisee agrees:

(1) To sell all and only the products and services required by EA, utilizing only the method and manner that EA prescribes, and to discontinue selling any such products or services as EA may disapprove in writing at any time;

(2) To comply with all EA approved procedures and techniques regarding shipment and delivery, including, without limitation, the acceptance and fulfillment of orders made pursuant to the EDIBLE CONNECT Program (defined in Section 5.D below) and making deliveries to customers only in vehicles EA approves;

(3) To operate the Franchised Business seven (7) days a week for the required hours of operation which EA shall set and may change from time to time in its sole and absolute discretion, unless otherwise agreed to by EA;

(4) To maintain in sufficient supply the inventory of authorized and approved products, materials, and supplies necessary to operate Franchised Business;

(5) To lease, purchase, install or otherwise obtain any and all Operating Assets EA may require from time to time, for the appropriate handling, preparation, presentation, selling, and delivery or shipment of any products and services to customers;

(6) To employ sufficient staff to operate the Franchised Business at all times and maintain the dress and appearance of employees (all other matters pertaining to employment are suggestions or recommendations only);

(7) To place or display at the Store Location (interior and exterior), and on all delivery vehicles, only the signs, emblems, lettering, logos, and display materials that EA approves from time to time;

(8) To use only signs, posters, advertising pieces, lighting, storefront fixtures, displays, labels, forms, other paper products imprinted with the Marks and color, and similar items, as prescribed from time to time by EA in the operation of the Franchised Business;

(9) To handle any customer complaints and related customer service issues (including providing complimentary products to customers), in compliance with EA's commitment to a 100% customer satisfaction policy and to reimburse EA for its costs and fees in responding to customer service issues on Franchisee's behalf;

(10) To keep the Franchised Business at all times under the direct, on-premises supervision of the Franchisee (or, if Franchisee is an entity, its managing shareholder, member, or partner) ("Managing Owner") or a certified, trained employee acting as the full-time on-site manager, and keep EA informed of the identity of the on-site manager(s) of the Franchised Business;

(11) To maintain and participate in all technology requirements and policies as EA may modify them from time to time, including, but not limited to, the System intranet and extranet, the Computer System, email communications, the EDIBLE CONNECT Program, and the System Website;

(12) To honor all credit, charge, courtesy or cash cards or other credit devices required or approved by EA, in compliance with standards applicable to electronic payments, including Payment Card Industry Standards or any equivalent thereof;

(13) To participate in any EA required gift card and customer loyalty program, including issuing and honoring gift certificates, coupons, and gift and loyalty cards;

(14) To comply with any maximum, minimum, or other prices for products and services that EA may establish from time to time (to the fullest extent allowed by law), including required participation in System-wide discount programs and promotions and accepting the revenue allocation negotiated by EA with other businesses in co-branding and other collaborative marketing activities;

(15) To participate in all advertising, marketing, and promotional programs, including merchandising components as EA may require;

(16) To maintain the condition and appearance of the Store Location consistent with EA's standards for the image of an EDIBLE® Business as an attractive, pleasant, and comfortable business;

(17) To maintain the equipment or improve the appearance and efficient operation of the Franchised Business, including replacement of such Operating Assets as required by EA;

(18) To secure and maintain in force at all times all required licenses, permits, and certificates relating to the operation of the Franchised Business and operate the Franchised Business in full compliance with all applicable laws, ordinances and regulations, including government regulations relating to occupational hazards, health, environment, employment, workers' compensation and unemployment insurance, and withholding and payment of federal and state income taxes, social security taxes, and sales and service taxes. (While Franchisee may solicit and collect tips on the revenue that the Franchised Business receives from the sale of products and services, any tips collected or received are intended to be for the benefit of employees of the Franchised Business, and Franchisee is solely responsible for properly allocating and disbursing tips in accordance with its terms and conditions of employment as well as any applicable federal, state, and local law.);

(19) To participate in any National or Franchisee Advisory Council, Area Advertising Cooperative, or similar council that EA establishes for the EDIBLE® Business franchise system and to pay any assessments or dues that EA charges franchisees for their administration and operation;

(20) To conduct all sales activities in a dignified manner and accurately promote, describe, and otherwise represent the services of the Franchised Business, and to refrain from any sales practice

which is unethical or may be injurious to the business of EA and/or other franchisees or the goodwill associated with the Marks;

(21) To ensure that the Franchised Business at all times maintains the highest moral standards of the community and the standards of EDIBLE® Businesses that EA establishes; and

(22) To comply with any other requirements related to aspects of operating and maintaining the Franchised Business that EA determines to be useful to preserve or enhance the efficient operation, image, or goodwill of the Marks and EDIBLE® Businesses or to maintain and protect the quality of products, service, and the EDIBLE® and EDIBLE ARRANGEMENTS® brand.

C. Approved Suppliers, Manufacturers, and Distributors.

(1) Right to Designate Suppliers. EA has the absolute right to designate and/or approve the suppliers, manufacturers, and distributors for the Operating Assets and other products and services necessary to operate the Franchised Business ("Approved Suppliers"), which may be EA, its affiliates, or third-parties. Franchisee may only purchase or source those items from Approved Suppliers at the prices they decide to charge. Franchisee understands that if EA or its affiliates are Approved Suppliers, they expect to make a reasonable profit on the items. EA and its affiliates have the right to receive payments from Approved Suppliers on account of their actual or prospective dealings with Franchisee and other franchisees and to use all amounts for any purposes they deem appropriate, unless otherwise agreed with an Approved Supplier.

(2) EA's Proprietary Equipment and Materials. Franchisee acknowledges and agrees that certain fruit cutting equipment, fruit and other product preparation equipment, and production posters that it may lease from EA or its Affiliates at the price EA or its Affiliates may set from time to time throughout this Agreement are proprietary to the system ("Proprietary Equipment"). Franchisee agrees that the lease of such Proprietary Equipment shall not be deemed a transfer of ownership of the Proprietary Equipment from EA or its Affiliates, notwithstanding any purported use by EA or its Affiliates of terms or words that may indicate that the Proprietary Equipment has been "purchased" or "sold." At the termination or expiration of this Agreement, Franchisee shall transfer possession of such Proprietary Equipment back to EA or its Affiliates pursuant to Sections 19.F and 19.G of this Agreement.

(3) Purchases from Former Franchisees. Franchisee may not under any circumstances, without EA's prior written consent (which EA has no obligation to grant), purchase or receive any or all Operating Assets from an existing or former EDIBLE® franchisee, whether or not that other franchisee's franchised business is operating or closed and whether or not the Operating Assets comply with EA's then-current specifications for such items.

(4) Approval of Additional Suppliers. EA may, in its sole discretion revise the list of Approved Suppliers at any time. If Franchisee proposes to use in the operation of the Franchised Business any Operating Assets or services from a supplier that is not an Approved Supplier, Franchisee shall first notify EA and submit samples and such other information as EA requires for examination and/or testing or to otherwise determine whether such Operating Asset or service, or such proposed supplier, meets its specifications and quality standards. EA may charge Franchisee a fee, not to exceed the actual cost of testing or examination. If EA does not approve Franchisee's

C. **Prohibition on Franchisee Withholding Payments.** Franchisee agrees that it will not withhold payment of any amounts owed to EA on the grounds of EA's alleged nonperformance of any of its obligations under this Agreement or for any other reason. EA may set off any amounts that Franchisee or its owners or affiliates owe EA, EA's affiliates, or others (whether under this Agreement or another agreement) against any amounts that EA or its affiliates owe Franchisee or its owners or affiliates (whether under this Agreement or otherwise). Franchisee specifically waives any right it may have at law or in equity to set off any funds or to fail or refuse to perform any of its obligations under this Agreement. Franchisee agrees to submit all claims, unless otherwise resolved by the parties' mutual agreement, pursuant to provisions of Section 20 below.

D. **General Provisions Concerning Default and Termination.** In any arbitration or other proceeding in which the validity of EAs termination of this Agreement or refusal to enter into a successor franchise agreement is contested, EA may cite to and rely upon all defaults or violations of this Agreement, not only the defaults or violations referenced in any written notice. Franchisee agrees that EA has the right and authority (but not the obligation) to notify any lender and any or all of Franchisee's owners, landlords, creditors, and/or suppliers if Franchisee is in default under, or EA has terminated, this Agreement.

19. FRANCHISEE'S OBLIGATIONS UPON TERMINATION OR EXPIRATION

A. **Effect of Termination or Expiration.** Upon termination or expiration of this Agreement, all rights granted to Franchisee under this Agreement shall immediately terminate including the license to use the Marks and Franchisee's right to operate the Franchised Business. Notwithstanding the foregoing, the following provisions shall survive the termination or expiration of this Agreement: Section 4.F., Section 8, Section 11.A.(2), Section 14, Section 15, Section 19, Section 20, Section 21, and Section 22.

B. **Cease Operating.** Upon termination or expiration of this Agreement, Franchisee shall immediately cease operating the Franchised Business and cease using any of the Marks and Confidential Information; provided however, that this Section 19.B. shall not apply to the operation by Franchisee of any other franchises under the System that EA may separately and independently have granted to Franchisee and that EA has not terminated.

C. **Modify the Premises.** If EA does not exercise its option to acquire the Franchised business at the Store Location pursuant to this Section 19, Franchisee shall make such modifications to the premises of the Franchised Business immediately upon termination or expiration of this Franchise Agreement as may be necessary to distinguish the appearance of the premises from that of other Edible® Businesses, and Franchisee shall make such specific additional modifications as EA may reasonably request for that purpose. If Franchisee fails to comply with the requirements of this Section 19, EA shall have the right to enter upon the Store Location without being guilty of trespass or any other tort to make such modifications, at Franchisee's expense, which Franchisee shall pay upon demand.

D. **Immediate Payment.** Upon termination or expiration of this Agreement, Franchisee shall immediately pay all sums owing to EA, its affiliates, and its approved or designated suppliers, through the effective date of termination or expiration.

E. **Liquidated Damages.** If this Agreement is terminated pursuant to Section 18, EA shall be entitled, as liquidated damages and not as a penalty and solely to compensate EA for damages due to

Exhibit C-Examples of Liquidated Damages

Franchisee's failure to continue operating the Franchised Business for the remainder of the Term, to a sum equal to:

(1) $15,000 to cover the administrative costs associated with the store closure; and,

(2) the average Royalties and Marketing Fees Cap owed by Franchisee (even if not paid) per month over the 12-month period preceding the date of termination (or, if the Franchised Business was not open throughout such 12-month period, then the average Royalties and Marketing Fees Cap earned per month for the period in which the Franchised Business was open), multiplied by the lesser of: (i) 18; or (ii) the number of months remaining in the Term.

This liquidated damages provision will not limit EA's right to injunctive relief relating to any violations of this Agreement, nor limit any damages available to EA arising out of such violations. Franchisee acknowledges and agrees that the amount of liquidated damages determined in accordance with the preceding formula reasonably represents EA's monetary losses resulting from the termination of this Agreement.

F. Return of Materials. Franchisee agrees, at its own cost and without any payment from EA, to return to EA, to make available to EA for pick-up, or to destroy (at EA's option), in any case within seven (7) days of termination or expiration of this Agreement, all signs, sign-faces, sign-cabinets, menu boards, marketing materials, forms, all copies of the Manuals, Confidential Information and any and all other materials provided by EA to Franchisee or created by a third party for Franchisee relating to the operation of the Franchised Business, and all items containing any Marks ("Proprietary Materials"); provided however, that Franchisee may retain Franchisee's copy of this Franchise Agreement, and correspondence between Franchisee and EA, and any other document which Franchisee needs for compliance with any applicable laws. Franchisee shall delete from the Computer System any proprietary information, including but not limited to products, methods of preparation, inventory and pricing. In the event that Franchisee fails to comply with this obligation, EA has the right to perform such obligations on Franchisee's behalf and at Franchisee's sole expense, including by contacting any vendor that services the Computer System to disable Franchisee's access and/or by physically seizing control and possession of the Computer System to perform such obligations on Franchisee's behalf. Franchisee is obligated to pay EA fifteen thousand dollars ($15,000) for all Confidential Information and Proprietary Materials not returned to EA when required.

G. Return of Proprietary Equipment. Franchisee agrees, at its own cost and without any payment from EA, to return to EA or to make available to EA for pick-up (at EA's option) within seven (7) days of termination or expiration of this Agreement the Proprietary Equipment. If Franchisee fails to do so voluntarily when EA requires, EA or its representatives may enter the Store Location at EA's convenience and remove these items without liability to Franchisee or third parties. Franchisee must reimburse EA's costs of doing so. Franchisee is obligated to pay EA fifteen thousand dollars ($15,000) for each piece of Proprietary Equipment not returned to EA when required.

H. Close Vendor Accounts. Franchisee must close all of Franchisee's accounts with suppliers which were opened in connection with the Franchised Business. EA has the right to notify Franchisee's suppliers that this Agreement has expired or been terminated and to require them to close Franchisee's accounts, if Franchisee fails to do so.

required hereunder, the prior notice, "good cause" standard, and/or other action required by such law shall be substituted for the comparable provisions hereof.

13.5. Assignment Upon Bankruptcy. If, for any reason, this Agreement is not terminated pursuant to this **Article 13**, and this Agreement is assumed, or assignment of the same to any person or entity who has made a *bona fide* offer to accept an assignment of this Agreement is contemplated, pursuant to the United States Bankruptcy Code, then notice of such proposed assignment or assumption, setting forth: (i) the name and address of the proposed assignee; and (ii) all of the terms and conditions of the proposed assignment and assumption, shall be given to Franchisor within 20 days after receipt of such proposed assignee's offer to accept assignment of this Agreement, and, in any event, within 10 days prior to the date application is made to a court of competent jurisdiction for authority and approval to enter into such assignment and assumption, and Franchisor shall thereupon have the prior right and option, to be exercised by notice given at any time prior to the effective date of such proposed assignment and assumption, to accept an assignment of this Agreement to Franchisor itself upon the same terms and conditions and for the same consideration, if any, as in the *bona fide* offer made by the proposed assignee, less any brokerage commissions which may be payable by Franchisee out of the consideration to be paid by such assignee for the assignment of this Agreement. In the event Franchisor does not elect to exercise the options described in this **Section 13.5**, any transfer or assignment pursuant to the United States Bankruptcy Code shall be subject to the same terms and conditions of any other transfer or assignment set forth in **Article 12**.

13.6. Damages / Early Termination Fees (Liquidated Damages). In addition to any other claims Franchisor may have (other than claims for lost future Royalty Fees and Brand Fund Contributions), if Franchisor terminates this Agreement based on Franchisee's default or if Franchisee terminates this Agreement in violation of its terms (including abandonment or failure to open), Franchisee must pay Franchisor liquidated damages calculated as follows: the greater of (i) the average of Franchisee's monthly Royalty Fees and Brand Fund Contributions due for the last 12 months (or for such shorter period of time that the Franchise has been in operation) before termination, or (ii) the average monthly amount which would be due based on the minimum fees set forth in **Section 4.2** for a period 37+ months after the Effective Date, multiplied by the lesser of 24 or the number of months remaining in the then-current term under **Section 2.1**, discounted to present value using the then-current prime rate of interest quoted by Franchisor's principal commercial bank; (iii) or $150,000 per Territory. The parties hereto agree that calculation of damages if Franchisor terminates due to default or if Franchisee terminates this Agreement in violation of its terms will be difficult to measure and quantify, and the damages described in this **Section 13.6** are a reasonable approximation of such damages, and are not a penalty. Additional damages which may be charged include, but are not limited to, 36 months of the amounts due for the Technology Fee, reduction in Franchisor's enterprise value attributable to the loss of the Franchisee, value of future rebates based on average

performance of all franchisees plus all other amounts and damages Franchisor could lawfully claim.

14. OBLIGATIONS UPON TERMINATION OR EXPIRATION

Upon termination or expiration of this Agreement, all rights granted hereunder to Franchisee shall forthwith terminate, and:

14.1. Cease Operations. Franchisee shall immediately cease to operate the Franchise, and shall not thereafter, directly or indirectly, represent to the public or hold itself out as a present or former franchisee of Franchisor.

14.2. Cease Use of Marks. Franchisee shall immediately and permanently cease to use, in any manner whatsoever, any confidential methods, procedures and techniques associated with the System, the mark "Wallaby Windows" and all other Marks and distinctive forms, slogans, signs, symbols, and devices associated with the System. In particular, Franchisee shall cease to use, without limitation, the Wallaby Vehicles, all signs, advertising materials, displays, stationery, forms, and any other articles that display the Marks.

14.3. Cancellation of Assumed Names. Franchisee shall take such action as may be necessary to cancel any assumed name or equivalent registration which contains the mark "Wallaby Windows" and all other Marks, and/or any other service mark or trademark of Franchisor, and Franchisee shall furnish Franchisor with evidence satisfactory to Franchisor of compliance with this obligation within five days after termination or expiration of this Agreement.

14.4. Assign Lease; Modification of Premises. Franchisor, or any affiliate of Franchisor, shall have the right and option, but not the obligation, in Franchisor's sole discretion, to acquire the Lease, or otherwise acquire the right to occupy the Franchise Location (if applicable). Franchisor may assign or delegate this right or option to any affiliate or designee of Franchisor, without notice to, or request for approval from, the landlord or lessor of the Franchise Location. If Franchisor or its assignee or delegatee does not elect or is unable to exercise any option it may have to acquire the Lease, or otherwise acquire the right to occupy the Franchise Location, Franchisee shall make such modifications or alterations to the Franchise Location operated hereunder immediately upon termination or expiration of this Agreement as may be necessary to distinguish the appearance of said premises from that of other Franchises, and shall make such specific additional changes thereto as Franchisor may reasonably request for that purpose. If Franchisee fails or refuses to comply with the requirements of this **Section 14.4**, Franchisor (or its designee) shall have the right to enter upon the premises of the Franchise, without being guilty of trespass or any other tort, for the purpose of making or causing to be made such changes as may be required, at the expense of Franchisee, which expense Franchisee agrees to pay upon demand.

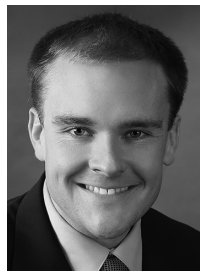
14.5. Telephone, Etc. Franchisee shall cease use of, and if Franchisor requests, shall transfer to Franchisor, all telephone numbers, customer lists, and any

Don't Tread on Me: A Defense of State Franchise Regulation

Caroline B. Fichter, Andrew M. Malzahn, and Adam Matheson

Ms. Fichter

Mr. Malzahn



Mr. Matheson

In the words of U.S. Supreme Court Justice Louis Brandeis, "it is one of the happy incidents of the federal system that a single courageous state may, if its citizens chose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country."[1] Brandeis urged that if courts are to be "guided by the light of reason," they "must let [their] minds be bold," and argued that "to stay the experimentation in things social and economic is a grave responsibility," adding that when courts are asked to exercise this power, "we must be ever on our guard."[2]

In the context of franchising, states have attempted to stop widespread abuses in the franchise industry by enacting statutes that both protected in-state franchisees from unscrupulous franchisors and punished bad-actor franchisors by prohibiting the most common abuses in the sale of franchises and the franchise relationship.[3]

The Federal Trade Commission explicitly recognized the importance of state regulation when it promulgated the Federal Trade Commission Rule on Franchising in 1979 (the FTC Rule). The FTC Rule states that "[t]he Federal Trade Commission does not intend to annul, alter, or affect, or exempt any persons subject to the provisions of this part from complying with the laws or regulations of any State, municipality, or other local government

1. New State Ice Co. v. Liebmann, 285 U.S. 262 (1932).
2. *Id.* at 311.
3. *See generally* Peter Lagarias & Bruce Napell, *Lessons from Thucydides on Distinguishing Statutory from Common Law Fraud in Franchise Disclosure Action*s, 35 FRANCHISE L.J. 601 (2016).

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Exhibit E

with respect to franchising practices except to the extent that those laws or regulations are inconsistent with any provisions of this part, and then only to the extent of the inconsistency."[4] The FTC explained that the FTC Rule set a floor, not a ceiling, for franchise legislation: "a law or regulation of any State, municipality, or other local government is not inconsistent [with the FTC rule] if the protection such law or regulation affords any prospective franchisee is equal to or greater than that provided by this part."[5] The FTC encouraged states to enact more stringent franchise regulations, explaining that "the commission believes it is possible for state and local governments to enact franchise measures which provide greater protection, either because the governments are able to allocate greater resources to enforce efforts in this area or because their governments might uncover problems and devise solutions which are unknown at this time."[6]

A recent *Franchise Law Journal* article written by Daniel Oates, Vanessa Wheeler, and Katie Loberstein (the Oates Article)[7] argues that state franchise statutes are outdated,[8] less critical for today's franchisees,[9] and unconstitutional. Nothing could be further from the truth. State statutes are the embodiment of legislatures utilizing their judicially recognized rights as "laboratories of democracy" to protect franchisees and deter unethical practices in franchising according to each state's unique values and regulatory philosophy. Each state has tailored franchise statutes to address its own concerns and serve its values. States with a traditionally robust approach to consumer protection and securities regulation have drafted franchise statutes that protect franchisees and prohibit resident franchisors from engaging in sharp business practices.[10] Other states have taken a more *laissez-faire* approach and drafted statutes limited to protecting only franchises operating

4. 16 C.F.R. § 437.2 n.2.

5. *Id.*

6. Statement of Basis and Purpose, 43 Fed. Reg. 59614, 59721 (Dec. 21, 1978) (hereinafter, Statement of Basis and Purpose).

7. Daniel J. Oates, Vanessa L. Wheeler, and Katie Loberstein, *A State's Reach Cannot Exceed Its Grasp: Territorial Limitations on State Franchise Statues*, 37 FRANCHISE L.J. 185 (2017).

8. The Oates Article incorrectly describes state franchise statutes as "largely unchanged for nearly fifty years." *Id.* at 185. This assertion ignores the fact that most states have amended their statutes at least once since they were enacted. In 2015, California dramatically amended its franchise statute, making California now "home to the toughest franchisee-protection" laws in the nation. *See* Rochelle Spandorf, *New California Franchise Relations Act: A Game Changer for Franchisors Operating in California*, *available at* https://www.dwt.com/The-New-California-Franchise-Relations-Act-A-Game-Changer-for-Franchisors-Operating-in-California-10-28-2015/.

9. The Oates Article claims that the statutes were "hastily enacted" after a few "less-than-savory entrepreneurs" bilked franchisees out of their life savings. Oates Article, *supra* note 7, at 214. Not only does this argument minimize the fact-finding and drafting efforts of a half dozen state legislatures, but it implies that any statute enacted after a tragedy is inherently suspect. Under this theory, the safety legislation that was passed after the Titanic's sinking should be repealed. The comparison may seem absurd, but, like the Titanic's passengers, a franchisee in a bad system has purchased something that does not perform as promised, is in the middle of a disaster, and has no viable escape route.

10. *See, e.g.*, CAL. CORP. CODE § 31000 et seq. (1971).

in their state.[11] These laws are equally or more important today than when they were enacted because there remains an extreme imbalance of power between franchisors and franchisees.[12] Courts have repeatedly ruled a state may regulate the franchise relationship, even if some aspect of that relationship occurs outside its borders, without violating the Dormant Commerce Clause.

What follows here is a response to the Oates Article. It is organized into three main sections. Part I examines the history of franchise regulation and how states have enacted legislation to protect franchisees and punish unscrupulous franchisors. Part II responds to and adds to the state-by-state survey in the Oates Article. Part III presents recent empirical research and other arguments demonstrating why franchisees are still in need of protection. Part IV explains why the extraterritorial application of state franchise statutes does not pose constitutional concerns.

I. History of Franchise Regulations

The promise of franchising is that individuals can make money by realizing the American Dream: owning their own business.[13] Ideally, franchising benefits both franchisors (by providing a way to distribute a product or service without making a significant capital investment) and franchisees (by providing a way to make use of an established business model).[14] Franchising began growing in the 1950s. During the early franchise booms, consumers complained of franchise sales abuses, including misrepresentations about the value of a franchise; false claims related to earning potential; unfair refusal by franchisors to honor refund provisions; and failure to disclose material facts about franchise offerings.[15]

In the 1960s, Congress held numerous hearings. Various bills were introduced, but they failed to address the abuses in the franchise arena.[16] In 1971, the FTC initiated a rule-making process to address franchise abuses but the FTC Rule would not actually go into effect until October 21, 1979.

First faced with inaction, and then with serious delay at the federal level, several states acted to protect franchisees and punish bad-actor franchisors. In 1970, California became the first state to enact legislation regulating franchises with the California Franchise Investment Law.[17] Washington and Wisconsin followed suit in 1971 and 1972. Fifteen states enacted legislation specifically regulating the offer and sale of franchises, and as many as eigh-

11. *See, e.g.*, ARK. CODE ANN. § 4-72-201 (1977).
12. *See infra*, Part IV.
13. FRANCHISING: CASES, MATERIALS, AND PROBLEMS 2 (Alexander Moore Meiklejohn, 2013).
14. *Id.*
15. *See* Statement of Basis and Purpose, 43 Fed. Reg. 59614, 59628–38.
16. Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1512 (1990).
17. *Id.* at 58; *see also* CAL. CORP. CODE §§ 31000 to §§ 31513 (1970).

teen states have enacted statutes that regulate some aspect of the franchise relationship.[18] Some of these statutes were enacted before the implementation of the FTC Rule, while others were enacted after. All state legislatures that passed franchise statutes have revisited those statutes at least once since the FTC implemented the FTC Rule.

II. Responses and Additions to the Oates Article's State-by-State Survey

The Oates Article categorizes state franchise laws as "strict," "moderate," and "questionably broad." Categories aside, the limitations imposed by state boundaries do not foreclose franchisee claims. Specifically, state franchise acts can and should apply to out-of-state franchisees.

A. *Franchisees Are Protected Regardless of Whether a Territorial Limit Is Strict, Moderate or Broad*

1. "Narrow" Territorial Limits Are Applicable Only to Portions of State Franchise Acts

A closer look at the states with narrow extraterritorial provisions reveals that the narrow limitations apply only to portions of the particular act. Although some state franchise statutes require that a franchisee maintain a "place of business" in that state, an out-of-state franchisee's ability to bring claims is not entirely foreclosed in these states.

In Connecticut, certain provisions of the Connecticut Franchise Act (CFA) are limited to franchise agreements that require the franchisee to establish or maintain a place of business in Connecticut.[19] These limitations, however, apply only to franchise termination, while all other provisions of the CFA apply to franchisees irrespective of whether the franchisee maintains a place of business in Connecticut.[20]

Similarly, portions of the Hawaii Franchise Investment Law (HFIL) are territorially limited. Relying on select HFIL provisions to claim that it is narrowly tailored, the Oates Article omits other provisions of the HFIL that are not similarly limited.[21] For example, the antifraud section makes it unlawful for "any person in connection with the offer, sale, or purchase of any franchise directly or indirectly" to engage in various actions, only

18. ABA FORUM ON FRANCHISING, FUNDAMENTALS OF FRANCHISING, Appendix C (Rupert M. Barkoff et al., eds., 4th ed. 2015).

19. *See* CONN. GEN. STAT. § 42-133h (1985).

20. *See* CONN. GEN. STAT. § 42-133n (2006).

21. *See* HAW. REV. STAT. § 482E-3(a) (2004) ("It is unlawful for any person to sell a franchise in this State unless such person has presented to the prospective franchisee or the franchisee's representative, at least seven days prior to the sale of the franchise, an offering circular containing [various information.]"); HAW. REV. STAT. § 482E-5(a) ("Every person selling franchises in this State shall at all times keep and maintain a complete set of books, records, and accounts of such sales and shall thereafter at such times as are required by the director make and file in the office of the director a report setting forth the franchises sold by it and the proceeds derived therefrom.").

one of which is specifically limited to actions within Hawaii.[22] The HFIL goes on to state that "[a]ny person who is engaged or hereafter engaged directly or indirectly in the sale of a franchise or in business dealings concerning a franchise, either in person or in any other form of communication, shall be subject to this chapter, shall be amenable to the jurisdiction of the courts of this State, and shall be amenable to the service of process as provided by law and rule."[23] The plain language of the statute directly contradicts any contention that the HFIL is of limited scope and applies only to Hawaiian residents or franchises located in Hawaii.

2. Franchise Statutes with Territorial Limits May Still Apply to Out-of-State Franchisees

Even with a narrow extraterritorial limit, franchise statutes may still apply to out-of-state franchisees. For example, the Indiana Franchise Act (IFA) applies to franchises not physically located in Indiana. The IFA makes it "unlawful for any person in connection with the offer, sale, or purchase of any franchise, or in any filing made with the commissioner, directly or indirectly . . . to engage in any act which operates or would operate as a fraud or deceit upon any person."[24] The IFA applies to the offer of a franchise if the "offeree or franchisee is an Indiana resident."[25] Thus, a resident of Hammond, Indiana, who operates a franchise in Illinois may have a cause of action under the IFA even if the franchise is not located in Indiana.

The Iowa Franchise Act (IAFA) applies only to a new or existing franchise that "is operated in the state of Iowa."[26] The IAFA further states that "[t]he

22. HAW. REV. STAT. § 482E-5(b)(1)-(5)(2004) states:

> It is unlawful for any person in connection with the offer, sale, or purchase of any franchise directly or indirectly:
>
> (1) To make any untrue statement of a material fact in any offering circular or report filed with the director under this chapter or willfully to omit to state in any offering circular or report, any material fact which is required to be stated therein.
>
> (2) To sell or offer to sell a franchise in this State by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made not misleading.
>
> (3) To employ any device, scheme, or artifice to defraud.
>
> (4) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.
>
> (5) To violate any order of the director.

23. *See* HAW. REV. STAT. § 482E-3(c) (2004).

24. IND. CODE § 23-2-2.5-27(3) (2008).

25. IND. CODE § 23-2-2.5-2 (2008). *See*, *e.g.*, 7E Fit Spa Licensing Grp. LLC v. 7EFS of Highlands Ranch, LLC, No. 115CV01109TWPMPB, 2016 WL 4761562, at *9 (S.D. Ind. Sept. 13, 2016) (implying that the IFA would have applied to a franchise operating outside of Indiana if the court had found that the limited liability company operating the franchise was a resident of Indiana).

26. IOWA CODE § 523H.2 (1995); *see also* IOWA CODE § 537A.10.2. (2000), which has substantially similar language and applies to franchise agreements entered into on or after July 1, 2000.

provisions of this chapter do not apply to any existing or future contracts between Iowa franchisors and franchisees who operate franchises located out of state."[27] The Iowa legislature amended the latter provision in 1995 to clarify that the IAFA did not apply "between Iowa franchisors and franchisees who operate franchises located out-of-state."[28] Based on the latter provision, franchisors have argued that an Iowa franchisor dealing with an out-of-state franchisee who operates a franchise within Iowa does not need to comply with the IAFA.

The Iowa Supreme Court addressed this very argument in *Holiday Inns Franchising, Inc. v. Branstad*.[29] There, the court reviewed the legislative intent of the IAFA, which it noted was "to provide greater power to franchisees and place greater restrictions on the powers of franchisors."[30] Rejecting the franchisor's argument, the court reasoned that:

> [n]othing in the legislative history of this chapter supports the plaintiffs' contention that the general assembly intended to benefit Iowa franchisors in their dealings with out of state franchisees by excluding them from the reach of the chapter when the out of state franchisee operates a franchise within the borders of the state of Iowa.[31]

3. State Franchise Acts Are Interpreted in Accordance with the Spirit of the Statute

Several franchise statutes protect franchisees regardless of location. The Michigan Franchise Investment Law (MFIL) applies to "all written or oral arrangements between a franchisor and franchisee in connection with the offer or sale of a franchise. . . ."[32] The Michigan legislature directed courts to "broadly construe" the MFIL "to effectuate its purpose of providing protection to the public."[33] The Oates Article claims that the MFIL "appears to have a drafting mistake" because it is not limited to franchises "in this state."[34] But the legislature's choice not to include an "in this state" limitation reflects not poor drafting but rather an intent to provide broad protection to franchisees. Specifically, the MFIL requires that the franchise sale be "made" in Michigan.[35] Thus, the MFIL applies if the franchisee is domiciled in Michigan even if the franchise is not located, offered, accepted, or operated in Michigan. Similar to the Indiana/Illinois example above, this statute

27. *Id.*
28. *Compare* IOWA CODE § 523H.2 (1993) *with* IOWA CODE § 523H.2 (1995).
29. 537 N.W.2d 724 (Iowa 1995).
30. *Id.* at 729.
31. *Id.*
32. MICH. COMP. LAWS § 445.1504(1) (1984).
33. MICH. COMP. LAWS § 445.1501 (1984).
34. Oates Article, *supra* note 7, at 194–95.
35. *See* MICH. COMP. LAWS § 445.1504(2)–(3) (1984). This can be accomplished numerous ways, including: (1) if the offer to sell is made in Michigan; (2) an offer to buy is accepted in Michigan; (3) if the franchisee is domiciled in Michigan; or (4) if the franchised business is or will be operated in Michigan. *See* Ward's Equip., Inc. v. New Holland N. Am., Inc., 493 S.E.2d 516, 520–21 (Va. 1997) (applying Michigan law).

also fits with the legislators' purpose that the MFIL be broadly construed to protect the public.

The Florida Franchise Misrepresentation Act (FFMA) is also interpreted pursuant to the spirit of the law. The FFMA makes it unlawful, when selling or establishing a franchise or dealership, for any "person" intentionally to make various misrepresentations.[36] The FFMA defines a "person" as "an individual, partnership, corporation, association, or other entity doing business in Florida."[37] Notably, unlike the language in other state statutes that indicate the statute applies to franchises physically located in that state, the FFMA merely requires that the party do business in Florida.

In 2006, the U.S. District Court for the Southern District of Florida clarified what "doing business in Florida" requires in *Lady of America Franchise Corp. v. Malone*.[38] Lady of America Franchise Corp. (LOA) argued that the FFMA did not apply because the former franchisee, Malone, operated a franchise in Michigan.[39] The franchisor was a Florida corporation with its offices in Florida, and the parties' agreement contained a choice-of-law provision applying Florida law. The court reasoned that "even though Malone's franchise was not located in Florida, LOA, a franchisor that does business in Florida, is the 'person' that allegedly made the misrepresentations" and is subject to the FFMA.[40] Accordingly, the court denied LOA's motion to dismiss.

B. *Franchisees Are Protected by Other State Statutes*

Franchisees that are harmed by franchisors, but without recourse due to the territorial limitations in state franchise statutes, might still assert claims under other state statutes. For example, the Connecticut Unfair Trade Practices Act (CUTPA) provides that "[n]o person shall engage in unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce."[41] The definition of "person" includes a corporation, limited liability company, and any other legal entity.[42] Connecticut courts have determined that even if the Connecticut Franchise Act does not apply, the "conduct of the [franchisor] may still violate CUTPA where the [franchisor's] actions violate the public policy of this state as expressed 'within at least the penumbra of some common law, *statutory*, or other established concept of unfairness.'"[43] Thus, although some provisions of the Connecticut Franchise Act are limited to franchises that maintain a place of busi-

36. FLA. STAT. § 817.416(2)(a)(1)–(3) (1971).
37. FLA. STAT. § 817.416(1)(a) (1971).
38. No. 05-61304-CIV, 2006 WL 7354110, at *2 (S.D. Fla. Feb. 13, 2006).
39. *Id.*
40. *Id.*
41. CONN. GEN. STAT. § 42-110b(a) (1976).
42. CONN. GEN. STAT. § 42-110a(3) (2004).
43. Diesel Injection Serv. Co. v. Jacobs Vehicle Equip. Co., No. X04CV980120289S, 2002 WL 959894, at *3 (Conn. Super. Ct. Apr. 16, 2002) (quoting Willow Springs Condo. Ass'n, Inc. v. Seventh BRT Dev. Corp., 245 Conn. 1, 43 (Conn. 1998)) (emphasis in the original).

ness in that state, Connecticut does not leave other franchisees without a remedy.

The Indiana Deceptive Franchise Practices Act (IDFPA) also applies to franchisees even if they do not operate a franchise in Indiana. The IDFPA prohibits a franchise agreement from containing certain provisions in an agreement between any franchisor and a franchisee "who is *either a resident of Indiana* or a nonresident who will be operating a franchise in Indiana."[44] Like the Indiana Franchise Act, the IDFPA applies to residents of Indiana (regardless of whether they operate a franchise in Indiana) and non-residents (who operate a franchise in Indiana).

III. Franchisees Still Need Statutory Protection at the State Level

In making its argument that extraterritorial application of state franchise statutes is unconstitutional, the Oates Article relies on the faulty premise that "yesterday's" franchise laws are less or no longer necessary or as important for "today's" franchisees.[45] However, this assertion ignores the fact that today's franchisees invest larger sums of money,[46] sign more onerous franchise agreements (often on a take-it-or-leave-it basis),[47] and often enter into the relationship without consulting an attorney.[48] As a result, prospective franchisees and existing franchisees are equally susceptible to fraud and other abuses today as they were many years ago, and the damages resulting from this misconduct are far higher.

A. *The Imbalance of Power Between Franchisors and Franchisees and the Fallacy That Franchisees Are Less Vulnerable or More Sophisticated*

The franchisor/franchisee relationship has appropriately been described as "[t]he Reliance Relationship: Superiority and Inexperience."[49] Consider its basic structure. Franchisors purport to have developed a unique and established business model capable of replication by franchisees. This type of offering naturally attracts individuals seeking to own a business despite having no prior experience because they perceive it as a reduced-risk investment that is already "proven."[50] The end result is the marriage of a sophis-

44. IND. CODE. § 23-2-2.7-1(1) (1987) (emphasis added).

45. Oates, *supra* note 7, at 185–86, 214–15.

46. The total Estimated Initial Investment for a Subway franchise is $147,050 to $320,700. *See* Subway May 1, 2017 FDD, Item 7. The total Estimated Initial Investment for a Burger King franchise is $317,100 to $3,046,600. *See* Burger King April 28, 2017 (as amended October 20, 2017) FDD, Item 7.

47. Oates Article, *supra* note 7, at 214.

48. *See infra*, Part IV.A.

49. Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 961 (1990) ("the reliance relationship created by the franchisor's relative superiority and the franchisee's relative inexperience is an essential component of the typical franchise exchange").

50. Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 ALB. L. REV. 193, 203–04 (2013).

ticated party with a relatively unsophisticated party. Franchisors generally are large, sophisticated companies with significant legal and financial resources,[51] whereas franchisees are individuals with fewer resources and limited business ownership or industry-specific experience, who are attracted to franchising because the franchisor has promised to train and assist them.[52]

This imbalance of power between franchisor and franchisee, and the relative lack of sophistication of franchisees, have been repeatedly verified with empirical evidence, including by the authors in a survey of their own.[53]

1. Franchisees Frequently Have No Prior Experience as Business Owners and No Prior Industry Specific Experience

Recent empirical evidence reveals that "new franchisees are unlikely to possess franchise unit ownership experience, or even any prior business ownership [experience]."[54] According to one study of 307 franchisees, "only 20 percent of the sample had actually been business owners before becoming franchisees."[55] Another study of seventy-four franchisees in a single franchise system revealed that only 6.7 percent of franchisees had owned an independent business prior to joining the franchise system.[56] In a survey that FranchiseGrade.com conducted of more than 1,100 franchisees nationwide, 63 percent of franchisees had never owned any type of business prior to becoming a franchisee.[57] Moreover, a substantial percentage of franchisees have no experience in the industry or sector in which they currently operate their franchises.[58]

51. Service Employees International Union, *Petition for Investigation of the Franchise Industry*, at p. 2 (May 19, 2015), *available at* https://www.americanbar.org/content/dam/aba/publications/franchise_lawyer/ftc-req-for-investigation_final-may-19-2015.authcheckdam.pdf. Indeed, the top twenty-five U.S. franchisors account for 21 percent of all franchised units in the country, with combined revenue over $50 billion. *Id.* at p. 4 (compiling data from each of the top twenty-five franchisors' FDDs and SEC Form 10-Ks).

52. Emerson & Benoliel, *supra* note 50, at 203–04. Indeed, individuals with no or little relevant experience find franchising attractive, in part, because franchising promises site selection assistance, training, and operations manuals.

53. The authors conducted a survey of franchisees nationwide across several franchise systems and received 253 franchisee responses. The results of the survey are summarized in Appendix A, *infra*, Tables 1–6.

54. Emerson & Benoliel, *supra* note 50, at 206–09.

55. *Id.* at 206–07 (citing Kimberley A. Morrison, *An Empirical Test of a Model of Franchisee Job Satisfaction*, 34 J. Small Bus. Mgmt. 27, 30–31 Table 2 (1996)).

56. Emerson & Benoliel, *supra* note 50, at 216 (citing Alden Peterson & Rajiv P. Dant, *Perceived Advantages of the Franchise Option from the Franchisee Perspective: Empirical Insights from a Service Franchisee*, 28 J. Small Bus. Mgmt. 46, 49–50 Table 1 (1990)).

57. FranchiseGrade.com, *National Survey of Franchisees 2015—An Analysis of Survey Results*, at p. 9 (2015), http://wearemainst.com/wp-content/uploads/2015/04/Nat-Survey-Franchisees-2015.pdf.

58. In the FranchiseGrade.com study, 69 percent of franchisee respondents had no management experience in the industry in which they currently franchised before becoming a franchisee, and 48 percent had never worked in that industry. *See National Survey of Franchisees 2015*, *supra* note 57, at 10–11. Emerson and Benoliel's review of empirical evidence yielded similar results. *See* Emerson & Benoliel, *supra* note 50, at 207.

Certain franchisors and certain franchisee recruiting websites specifically seek out inexperienced individuals. One franchisee recruiting website has a specific sub-category entitled: "No Experience Needed Franchises."[59] Franchisor websites similarly tout opportunities for individuals with no experience,[60] as exemplified by another website luring individuals to franchising with the following statement:

> For most careers, a degree of previous experience has to be demonstrated in order to get hired and be successful in that role [. . .] This practice seems straightforward and logical—and is the reality for most professionals. However, in the franchise world, this concept doesn't quite seem to apply. A quick glance at many franchise sales websites, and you'll see "no previous experience required.". . .[61]

2. Franchisees Frequently Do Not Consult with an Attorney Prior to Signing Their Franchise Agreements

In the authors' survey, 52 percent of franchisees did not consult with an attorney to review their franchise agreement or FDD/UFOC before purchasing their first franchise.[62] Another survey of "franchisor" attorneys revealed that franchisees were represented by counsel at signing just 26 percent of the time; even when franchisees were represented, as one franchisor attorney commented, it was often by general practitioners unfamiliar with franchise law.[63] Regardless, franchise agreements are often offered on a take-it-or-leave-it basis.[64] Even if negotiated, the changes made are often few and far between.[65]

Failing to appropriately assess the legal risks and nuances of franchising is further evidence of franchisees' lack of sophistication. Without the aid of counsel, franchisees will have difficulty sifting through the overwhelming

59. Franchise Solutions, https://www.franchisesolutions.com/business-services/no-experience-needed (last visited Jan. 29, 2018).

60. *See, e.g.*, Real Property Management, https://www.propertymanagementfranchise.com/no-experience-necessary/ (last visited Jan. 29, 2018); Watch Dog Home Inspections, https://www.watchdogsfranchise.com/own-a-franchise/no-experience-necessary/ (last visited Jan. 29, 2018).

61. ServiceBridge, https://www.servicebridge.com/articles/no-experience-needed-field-service-franchises (last visited Jan. 29, 2018).

62. *See* Appendix A, *infra*, Table 1. Additionally, in only 23 percent of instances did the franchisor's salesperson expressly tell franchisees that they could hire an attorney to review their franchise agreement. *See id.*, Table 2.

63. Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether to Hire Counsel*, 51 SAN DIEGO L. REV. 709, 718 (2014) (citing its own "Franchise Lawyer Survey").

64. Some courts have correctly found that franchise agreements are contracts of adhesion. *See* Kubis & Perszyk Assocs., Inc. v. Sun Microsys., Inc., 680 A.2d 618 (N.J. 1996); Indep. Ass'n of Mail Box Ctr. Owners v. Super. Ct., 133 Cal. App. 4th 396 (2005); Ticknor v. Choice Hotels, Int'l, Inc., 265 F.3d 931 (9th Cir. 2001).

65. In the authors' survey, 27 percent of franchisees reported that their franchise salesperson expressly stated that their franchisor would not make any changes to the franchise agreement. *See* Appendix A, *infra*, Table 3. In the FranchiseGrade.com survey, 59 percent of the franchisees did not propose any changes; 28 percent had their proposed changes rejected; and only 13 percent of franchisors accepted at least one change to the franchise agreement. *See National Survey of Franchisees 2015*, *supra* note 57, at 13.

amount of information in the FDD and franchise agreement, as well as all other prospective information.[66] The inability to modify the one-sided provisions of a franchise agreement further compounds the imbalance of power.

3. Franchise Agreements Uniformly and Overwhelmingly Favor Franchisors

Standard, one-sided franchise agreements increase the imbalance of power. Franchise agreements are written by franchisors (and their attorneys) for franchisors.[67] As explained in Part II(B), *infra*, franchisees, compared with the franchisor, are at a significant disadvantage when it comes to their contractual rights and obligations.

4. The Majority of Franchisees Are Indeed Small Business Owners

Franchisees are often appropriately characterized as "small business owners." In the words of the longtime franchisor attorney and advocate, Bill Killion, "franchising is still dominated by the single-unit operator. . . ."[68] As Killion observes, FRANdata's database of 180,000 franchisees and 255,000 unit addresses from 1,300 brands reveals that 51 percent of all units were owned by single-unit operators.[69] The authors' survey yielded similar results, with 47 percent of franchisees claiming to own just one unit and another 21 percent owning just two units.[70]

5. The Franchise Structure Leaves Franchisees in a Vulnerable Position

In a typical franchise arrangement, a franchisee pays the franchisor an initial franchise fee and then incurs significant expenses to locate a site, secure a lease, build out the premises, and comply with the franchisor's exacting standards and specifications.[71] Frequently, franchisees take on loans, sign personal guaranties, and depend upon profits from the franchised business as their sole source of income.[72] Moreover, an unprofitable franchisee generally has no contractual right to terminate the franchise agreement because the franchisee is losing money. The franchisee may remain bound to a lease, may obtain only minimal salvage value for highly specific supply and equipment purchases, may be personally liable for the current and future debts of the franchise, and is at risk of bankruptcy.[73] By making a sunken investment in a highly specific business, franchisees are incentivized to stay in business

66. *See infra*, Part IV.C.
67. *See* Peter C. Lagarias & Edward Kushell, *Fair Franchise Agreements from the Franchisee Perspective*, 33 FRANCHISE L.J. 3, 3 (2013) (noting that "[f]ranchise agreements are written by franchisors and seldom reflect the interests and concerns of franchisees").
68. William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for A More Balanced View of the Franchisor-Franchisee Relationship*, 28 FRANCHISE L.J. 23, 28 (2008).
69. *Id.*
70. *See* Appendix A, *infra*, Table 4.
71. Lagarias & Kushell, *supra* note 67, at 4.
72. *Id.*
73. Hadfield, *supra* note 49, at 960.

despite losing additional money because the costs of exiting are too high.[74] This leaves franchisees susceptible to franchisor "opportunism."[75]

In contrast, the franchisor's risk is minimal. Aside from the opportunity cost of training and working with the franchisee, the franchisor has almost nothing invested. A franchisor will be paid a nonrefundable initial franchise fee and other ongoing fees until the franchisee stops operating.[76] A franchisor usually reserves the right to repurchase equipment at salvage value, use it elsewhere, and resell the franchise, earning yet another franchise fee.

B. *Franchise Agreements Today Are Not What They Used To Be*

Any progress made by franchisees since the first wave of franchise laws has been offset by the modern franchise agreement.

Although courts have ruled both ways on the issue, many courts still do not find a franchise agreement to be a contract of adhesion. These courts consider franchise agreements to be "commercial contracts" and follow a misguided blanket rule that all franchise agreements are freely negotiated.[77] However, franchise agreements in most cases *are* contracts of adhesion. The imbalance of power between franchisors and franchisees and the relative lack of franchisee sophistication found in the majority of franchise relationships render franchise agreements as adhesion contracts that are not freely negotiable.[78]

Common provisions in franchise agreements demonstrate why modern franchisees still need protection through various state franchise laws.[79]

1. The Franchisor's Right to Modify the System at the Franchisee's Expense

Franchise agreements often reference the franchisor's unique "System" and stress the franchisee's obligation to comply with the System in all re-

74. *Id.* at 951–52.

75. *Id.* Franchisee investments are so specific that, once expended, they are not easily recoverable if the franchisee goes out of business. And if franchisees do go out of business, they are likely to be sued for damages for early termination of the agreement.

76. Additionally, many franchisors seek lost future royalties and marketing fund fees from the franchisee if the franchise agreement is prematurely terminated.

77. *See, e.g.*, Shaffer v. Graybill, 68 F. App'x 374, 377 (3d Cir. 2003) ("We are unaware of any relevant cases in which the court has found an adhesion contract when dealing with the purchase of a franchise rather than a consumer purchase."); *In re* Tornado Pizza, LLC, 431 B.R. 503, 513 (Bankr. D. Kan. 2010) ("In this case the Franchise Agreements were not consumer transactions, and Debtor cannot prevail under Kansas law on the premise that the termination provisions of the Franchise Agreements are unenforceable adhesion contracts.").

78. *See supra* note 65 citing empirical evidence that clearly shows that franchise agreements are almost always non-negotiable; *e.g.*, *supra* note 64 (citing cases in which courts that have correctly found that franchise agreements are contracts of adhesion).

79. The following provisions are found in most modern franchise agreements. Peter Lagarias and Edward Kushell observed the "Commonality in Franchise Agreements," specifically, ten common one-sided provisions, in their article *Fair Franchise Agreements from the Franchisee Perspective*. *See* Lagarias & Kushell, *supra* note 67. The Service Employees International Union also reviewed the franchise agreement of fourteen large franchisors, totaling over 94,000 franchise units, and observed that the franchise agreements were all strikingly similar and one-sided. *Petition for Investigation of the Franchise Industry*, *supra* note 51, at 7–9.

spects. Because of the unpredictability of market conditions over the long term of franchise agreements (often ten or more years), franchisors invariably reserve the right to modify the System, through the operations manual or by other directives, in the franchisor's "sole discretion" or "business judgment," all at the franchisee's sole expense.[80] Indeed, a typical business judgment rule provision leaves no doubt that a franchisor may act in its own self-interest without regard to the franchisee.

Such extensive reservations tilt the battlefield in the franchisor's favor when tension inevitably arises from a franchisor's modification of the System. For example, a System modification may result in franchisees being forced to fund expensive promotional programs; renovations; or equipment, software, and hardware upgrades. The franchisor's express right to make certain changes, coupled with its unbridled discretionary standard, may even be outcome determinative in favor of the franchisor when franchisees challenge the system changes under the principle of good faith and fair dealing.[81]

With these types of provisions, franchisees have to choose between complying with the franchisor's directive, even if the investment is cost-prohibitive,[82] or challenging the changes under the franchise agreement's dispute resolution procedures and facing an uphill (and expensive) battle.[83]

2. Territorial Provisions

Territorial provisions in franchise agreements operate as *de facto* reservations of the franchisor's rights to encroach upon its franchisees. Depending on the franchise system, a franchisee may or may not receive an exclusive territory. In the worst-case scenario, a franchisee has no exclusive territory, allowing the franchisor or a third-party franchisee to operate a competing

80. *See* Lagarias & Kushell, *supra* note 67, at 7 (franchisors often reserve the right to modify the "System" "at will or under its sole discretion"); Brian B. Schnell, Ronald K. Gardner, Jr., *Battle over the Franchisor Business Judgment Rule and the Path to Peace*, 35 FRANCHISE L.J. 167, 168 (2015) (noting that, "[i]n recent years, however, franchisors have sought to replace or frame the good faith and fair dealing discretionary standard with a corporate law doctrine: the business judgment rule.").

81. *See*, *e.g.*, Johnson v. Arby's Inc., Bus. Franchise Guide (CCH) ¶ 12,018 (E.D. Tenn. Mar. 15, 2000) (permitting Arby's to require that new stores comply with its new building design in part because Arby's reserved its "sole discretion" to implement system standard changes in its operations manual); *see also* La Quinta Corp. v. Heartland Props., LLC, 603 F.3d 327 (6th Cir. 2010); Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306 (11th Cir. 2009).

82. For instance, in 2014, Wendy's sued one of its largest multi-unit franchisees for failure to remodel its franchises (estimated to cost $450,000 to $650,000 per franchise) and for failure to install a new point-of-sale system. Dan Eaton, *One of Wendy's Biggest Franchisees Won't Follow Remodeling Program, Gets Sued*, COLUMBUS BUS. FIRST, Dec. 31, 2014, https://www.bizjournals.com/columbus/news/2014/12/31/one-of-wendy-s-biggest-franchisees-won-t-follow.html?page=all. In turn, the franchisee countersued, claiming that remodeling its restaurants would provide no return on investment and would cost $75 million in the aggregate. Beth Ewan, *Wendy's Remodel Offers "No ROI," DavCo Counters in Lawsuit*, FRANCHISE TIMES, Feb. 19, 2015, *available at* http://www.franchisetimes.com/news/February-2015/Wendys-Remodel-Offers-No-ROI-DavCo-Counters-in-Lawsuit/.

83. For information on the one-sided dispute resolution procedures, *see infra*, Part III.B.6.

franchise in any location, regardless of the proximity to, or the financial impact on, the franchisee.[84]

Additionally, in nearly all franchise agreements, whether the franchisee has an exclusive or non-exclusive territory, franchisors still reserve the right to compete with their own franchisees through alternative methods.[85]

Permitting or encouraging intra-brand competition among franchisees in close proximity is especially harmful because franchisee customers generally have no allegiance to particular locations but rather to the uniform products and services offered at all franchise locations.[86] If a second franchise location is opened nearby or a franchisor begins competing over the Internet, the competition for the same customers inevitably cannibalizes sales.[87]

Franchisees in the 1990s had some success fighting off franchisor encroachment under the principle of good faith and fair dealing;[88] however, more recently several courts ruled that if the franchise agreement expressly permits the franchisor to open a competing franchise wherever it chooses, the implied covenant of good faith and fair dealing cannot override the express terms of a franchise agreement.[89] As a result, these territorial provisions and reservations can have a devastating effect on franchisees' profitability.

3. Restrictions on Renewal

Standard franchise agreements are for a fixed initial term and either expressly provide that the franchisee may renew the franchise only subject to

84. For instance, the McDonald's franchise agreement states: "[t]his Franchise establishes the Restaurant at the location specified on page 1 hereof only and that no 'exclusive,' 'protected,' or other territorial rights in the contiguous market area of such Restaurant is hereby granted or inferred. . . ." *See* McDonald's May 1, 2017 (as amended Aug. 1, 2017) FDD, Exhibit B, Franchise Agreement (Traditional) § 27(e). Burger King's franchise agreements states: "This franchise is for the specified location only and does not in any way grant or imply any area, market or territorial rights proprietary to Franchisee." *See* Burger King April 28, 2017 as (amended Oct. 20, 2017) FDD, Exhibit C, Franchise Agreement § 1.

85. *See, e.g.*, Massage Envy's April 20, 2017 FDD, Exhibit B, Franchise Agreement §§ 1(C), (D) (containing some, but not all, of the typical franchisor reservations to compete with franchisees).

86. Lagarias & Kushell, *supra* note 67 at 13.

87. *Id.*

88. *See* Scheck v. Burger King Corp., 756 F. Supp. 543 (S.D. Fla. 1991); *In re* Vylene Enters., 90 F.3d 1472, 1477 (9th Cir. 1996).

89. *See* Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999) (refusing to follow Scheck v. Burger King Corp.); *see also* Cohn v. Taco Bell Corp., No. 92-cv-5852, 1994 WL 13769, at *6 (N.D. Ill. Jan. 14, 1994) (no breach of the implied covenant of good faith and fair dealing where a franchise agreement contains a provision that expressly permits the franchisor to open competing franchises or company stores wherever it wants); Servpro Indus., Inc. v. Pizzillo, No. M2000-00832-COA-R3, 2001 WL 120731, at *4 (Tenn. Ct. App. Feb. 14, 2001) (allegations of encroachment do not constitute a claim for breach of the implied covenant of good faith and fair dealing where there is no evidence that the franchisor "bore any kind of malice against" the franchisee, that the franchisor "wished to damage or destroy [the franchisee's] franchise," or that the franchisor "colluded with" a competing franchisee to expand the competing franchise allegedly at the expense of the plaintiff franchisee); *but see* Handlers-Bryman v. El Pollo Loco, Inc., Case No. MC026045 (Cal. Super. Ct. Mar. 30, 2017) (holding that a "reservation of rights" clause for a franchisor to put a store wherever it wanted when there was no exclusive territory was unconscionable and unenforceable).

several onerous renewal conditions[90] or that the franchisee has no right to renew.[91]

Having no renewal right is especially harmful because the franchisee develops all the goodwill and eventually has to stop operating the franchise, cannot sell it, and has to give it back to the franchisor. Even with renewal rights, the renewal conditions can significantly alter the status quo and make the mere continuance of operating as a franchisee not feasible.

4. Conditions to Transfer

Although franchisees are generally permitted to transfer their interests in the franchise agreement, most franchise agreements, similar to renewal provisions, force the franchisee to meet a host of onerous conditions.[92]

Conditions to transfer pose two major problems for franchisees. First, the franchisor may rely on these provisions to disrupt or slow down a sale.[93] By disrupting the sale, the franchisor can attempt to force the franchisee to sell to a preferred buyer or purchase the franchise itself at a discount. Second, by forcing the franchisee or the transferee to modernize the franchise in accordance with current system standards, or by forcing a transferee to sign the franchisor's then-current form of franchise agreement, a franchisor can make the franchise much less valuable and drive down the sale price.

90. Common renewal conditions include: (1) the franchisee must sign the franchisor's then-current form of franchise agreement (the terms of which may be materially different from the franchise agreement, including the royalty and other ongoing fees); (2) the franchisee must modernize, renovate, or update the franchise premises, equipment, operating system, or otherwise (with no limit on the expense of such requirements); (3) the franchisee must sign a release of all claims against the franchisor or its affiliates; (4) the franchisee must pay a renewal fee; and (5) the franchisee must be in compliance with, or have never defaulted on, not only that specific franchise agreement, but all other agreements entered into with the franchisor. *See* Dunkin' Donuts' April 3, 2017 FDD, Exhibit B-1, Franchise Agreement § 2.4(b) (containing some, but not all, of these typical provisions).

91. For instance, the McDonald's current form franchise agreement expressly provides that there is "no promise or representation as to the renewal of this Franchise or the grant of a new franchise. . . ." *See* McDonald's May 1, 2017 (as amended Aug. 1, 2017) FDD, Exhibit B, Franchise Agreement (Traditional) § 27(a).

92. Common transfer conditions include: (1) the transferee must sign the franchisor's then-current form of franchise agreement (the terms of which may be materially different from the franchise agreement, including the royalty and other ongoing fees); (2) the franchisee or transferee must modernize, renovate, or update the franchise premises, equipment, operating system, or otherwise (with no limit on the expense of such requirements); (3) the franchisee must have never been in default of the franchise agreement or any other agreement entered into with the franchisor or the franchisor's affiliates; (4) the transferee must meet the franchisor's criteria for new franchisees; (5) the franchisee or the transferee must pay a transfer fee; and (6) the franchisee must first provide the franchisor with the right of first refusal to purchase the business on the same terms as the transferee. *See, e.g.*, Massage Envy's April 20, 2017 FDD, Exhibit B, Franchise Agreement § 12(D) (containing some, but not all, of these typical provisions).

93. See, e.g., Burger King Corp. v. H&H Rest., LLC, 2001 WL 1850888 (S.D. Fla. Nov. 30, 2001) (finding that Burger King Corporation did not unreasonably withhold its consent to a proposed transfer because it had the "sole discretion" to determine whether the proposed transfer was acceptable).

5. Cross-Default Provisions

In most franchise agreements, cross-default provisions grant the franchisor the right to terminate a franchise agreement if the franchisee defaults under any other agreement entered into with the franchisor or its affiliates. Cross-default provisions are becoming more common and are extremely dangerous because franchisees are commonly required to enter into leases and additional ancillary "supplier," "software," or "hardware" license agreements with their franchisors or their affiliates, and because franchisees may enter into additional franchise agreements with their franchisor in the future. Cross-default provisions, if enforced, provide franchisors with an extreme amount of leverage over franchisees and further perpetuate the imbalance of power. By using such a provision, a franchisor can, or can threaten to, take multiple franchises away from the franchisee for numerous reasons—even if the default is an inadvertent mistake or unrelated to the operation of the franchise.[94]

6. Dispute Resolution Provisions

Most modern franchise agreements contain extensive dispute resolution procedures that favor the franchisor. Franchisees are often forced to agree: (1) to arbitrate in the franchisor's home state; (2) to accept that the law applied to all disputes is the law of the franchisor's home state; (3) to waive the right to a jury trial; (4) to limited damages; (5) to shortened statutes of limitations; (6) to not join with other franchisees as a class to file an action against the franchisor for common problems; and (7) to pay their franchisors' attorney fees and costs if they bring a lawsuit against the franchisor and the franchisor prevails.

These provisions can make it costly, and even cost-prohibitive, for a franchisee to bring a claim against its franchisor.[95] Additionally, these provisions limit franchisors' litigation risks.[96]

The modern franchise agreement has evolved from fewer than ten pages to between thirty pages (on the low end) and ninety pages (on the high end), with multiple exhibits and ancillary agreements.[97] Prior franchise agreements were not so drastically one-sided.[98] Today, franchise agreements have evolved to in-

94. *See, e.g.*, Gun Hill Rd. Serv. Station, Inc. v. ExxonMobil Oil Corp., No. 08 CIV. 7956 PKC, 2013 WL 395096, at *11 (S.D.N.Y. Feb. 1, 2013).

95. *See infra*, Part III.E (noting a Florida franchisee testifying about the devastating expenses for franchisees seeking to vindicate their rights according to franchise agreement dispute resolution procedures); Lagarias & Kushell, *supra* note 67, at 23–29 (detailing the significant costs for franchisees to follow the procedures in the franchise agreement for dispute resolution).

96. Lagarias & Kushell, *supra* note 67, at 23–29.

97. *Id.* at 4. Massage Envy's 2017 franchise agreement is fifty-two pages, excluding attachments, and Burger King's 2017 franchise agreement for individuals is thirty-three pages, excluding attachments. *See* Massage Envy's April 20, 2017 FDD, Exhibit B, Franchise Agreement; Burger King's April 28, 2017 (as amended Oct. 20, 2017) FDD, Exhibit C, Franchise Agreement.

98. One example of the evolving nature of franchise agreements is the relatively new "business judgment rule" provision setting forth an extremely lenient discretionary standard for franchisors. *See generally* Schnell & Gardner, *supra* note 80.

clude, in most cases, the entirely one-sided provisions noted above and many more.[99] The ultimate result is the perpetuation of the imbalance of power between the franchisor and franchisee.

C. *The "Balance of Information in the Age of the Internet" Does Not Diminish the States' Legitimate Interest in Regulating Franchisors*

The Oates Article argues that franchisees no longer need the protection of state franchise laws because there has been "a dramatic change in the access individuals have to information on about business, finance, and the law."[100] This has, as the Oates Article puts it, "diminished" the states' legitimate interest in regulating franchise sales.[101]

On the contrary, a large number of franchisees enter into a franchise agreement with no prior franchise experience, without an attorney reviewing the FDD or franchise agreement, and without the aid of counsel in negotiating the franchise agreement's terms.[102] Inevitably, prospective franchisees will simply be unaware of the business and legal risks of entering into a franchise agreement. The Oates Article points out that prospects will have an FDD, a franchise agreement, and the Internet available to them.[103] But how helpful are each of these pieces of information for someone with no background in franchising, business, or the law?

Empirical evidence, as well as common sense, suggests that the information available to franchisees is less helpful than franchisor advocates believe.[104] Indeed, FDDs are dense, technical documents containing legal disclosures and financial data that are hundreds of pages in length.[105] Similarly, franchise agreements are filled with legal jargon and are generally more than thirty pages long. Sifting through these documents is a daunting task for anyone. It is no surprise that empirical evidence reveals that, rather than review, analyze, and understand FDDs, many franchisees ignore the FDD altogether.[106] Regardless, for those that do not completely ignore the FDD, the authors' survey revealed that 33 percent of franchisees either disagreed

99. Additional one-sided provisions not listed above include, but are not limited to, the franchisor's right to restrict the sourcing of franchisee required purchases of products and services; post-term non-competition clauses preventing the franchisees from working in their former line of work; and the franchisor's express right to sue for lost future profits (royalty and advertising fees).

100. Oates Article, *supra* note 7, at 214.

101. *Id.*

102. *See supra* Part IV.A.2.

103. Oates, supra note 7, at 214.

104. Emerson & Benoliel, *supra* note 50, at 215 (concluding that there is a false assumption that franchisees are sophisticated business people who consider all relevant information and make informed business decisions prior to entering into a franchise relationship).

105. For example, Subway's May 1, 2017 FDD, including exhibits, is more than 500 pages, and Burger King's April 28, 2017 (as amended October 20, 2017) FDD is more than 1,000 pages.

106. Kimberley A. Morrison, *An Empirical Test of a Model of Franchisee Job Satisfaction*, 34 J. SMALL BUS. MGMT. 27, 30–31, Table 2 (1996). As explained by Professors Emerson and Benoliel, a novice franchisee aspiring to own a franchise and reviewing all relevant information "will face

or strongly disagreed with the statement that the FDD was an accurate and complete description of the franchise investment.[107]

The Oates Article also assumes that information on the Internet is true, accurate, and reliable and that an average franchisee is capable of sifting through the information, identifying its source, and putting it to meaningful use. The authors believe that none of these assumptions reflects reality. Similar to a prospect reviewing an FDD and franchise agreement, franchisees searching the Internet for franchise information likely face the same "overwhelmed" feeling due to the sheer amount of information available. Further, how is a prospect to know what is accurate and credible, what is helpful and not helpful, who is providing this information, and what is the provider's motivation? Regardless, franchisors utilize merger and integration clauses to disclaim the very information that is suggested to help franchisees evaluate franchise opportunities. The franchisor's own documents state that it is unreasonable to rely upon anything not stated in the FDD. Yet, now franchisees are "protected" by information they specifically *may not* rely upon?

In reality, "the balance of information in the age of the Internet" does not level the playing field for franchisors and franchisees.

D. *Franchise Fraud, Deception, and Other Misleading and Abusive Practices Continue*

Despite a claimed increase in franchisee sophistication, statutorily mandated disclosures, and information on the Internet, franchisees today remain susceptible to fraud, deception, and other misleading and abusive practices at the hands of their franchisors. Empirical and anecdotal evidence proves this point. For instance, franchisees have complained about many franchisor actions: (1) the franchisor's FDD is not a complete and accurate description of the franchise investment;[108] (2) franchisors continue to make financial performance representations via the Internet and outside of Item 19 of the FDD;[109] (3) franchisors continue fraudulently to induce franchisees to enter into franchise agreements;[110] (4) franchisors terminate franchisees

three cognitive obstacles: the unawareness problems, screening difficulty, and comprehension limitations." Emerson & Benoliel, *supra* note 50, at 209–10.

107. *See* Appendix A, *infra*, Table 5.

108. Only 28 percent of franchisees in one survey agreed or strongly agreed that the franchisor's FDD is a complete and accurate description of the franchise investment, while 33 percent disagreed or strongly disagreed. *See* Appendix A, *infra*, Table 5.

109. In the authors' survey, 17 percent of franchisees stated that their franchise salesperson made statements related to sales, costs, and profits that were not included in the FDD or UFOC. *See* Appendix A, Table 6; *see also Petition for Investigation of the Franchise Industry*, *supra* note 51, at 12–13 (outlining blatant Item 19 violations in franchise advertisements such as "Makes more Money," ". . . recently launched locations hitting one million dollars of revenue in their first year," and "Profits, from day 1").

110. *See* Checkers Drive-In Rest., Inc. v. Tampa Checkmate Food Servs., Inc., 805 So. 2d 941, 943 (Fla. Dist. Ct. App. 2001).

and then sue them for "lost future profits;"[111] (5) franchisors improperly use money from system-wide advertising funds;[112] (6) franchisors attempt to intimidate franchisees and force them out of their franchises;[113] (7) franchisors retaliate against members of franchisee associations;[114] and (8) franchisors engage in the practice of "churning."[115]

As a result, the need for franchise laws protecting franchisees in both the sales process and throughout the relationship remains important today.

E. *Recent Franchise Legislation Demonstrates the Continuing Need for Statutory Protection for Franchisees*

The Oates Article claims that state franchise laws have "remain largely unchanged for nearly fifty years."[116] A survey of numerous states that continually propose and enact "pro-franchisee" laws, or propose and amend current franchise laws, stands in stark contrast not only to this claim, but also to the Oates Article's claim that the states' legitimate interest in regulating franchisors and franchisees has diminished over time. The testimony in support of recent franchise legislation and its stated purposes proves that inequities in the franchise relationship continue today.

For example, in 2007 Rhode Island enacted the Rhode Island Fair Dealership Act (RIFDA), which provides the typical protections found in franchise relationship laws.[117] Although RIFDA ended a seventeen-year drought in enacting franchise "relationship" laws in the United States, other efforts have been made but came up short.[118]

Most recently, in October 2015, California's legislature enacted sweeping franchise legislation, which has been described as "the toughest franchisee-protection law in the nation."[119], Specifically, the California Franchise Rela-

111. Postal Instant Press, Inc. v. Sealy, 43 Cal. App. 4th 1704, 1717 (1996) (franchisor terminated franchisee for missing royalty payments and sued for seven years of estimated "lost future profits" (royalties and advertising fees) for the remainder of the term of the franchise agreement).

112. *Tim Hortons franchisee group files new lawsuit against parent company*, NAT'L POST, Oct. 6, 2017, http://nationalpost.com/pmn/news-pmn/canada-news-pmn/tim-hortons-franchisee-group-files-lawsuit-against-parent-company (these allegations have not been proven at this preliminary stage).

113. Hollie Shaw, *Tim Hortons Franchisees Sue Corporate Parent for $850M, Alleging Bullying and Intimidation*, FIN. POST, Oct. 6, 2017, http://business.financialpost.com/news/retail-marketing/tim-hortons-franchisees-sue-corporate-parent-for-850m-alleging-bullying-and-intimidation (these allegations have not been proven at this preliminary stage).

114. Sean Kelly, *7-Eleven Whistleblower Alleges Predatory Practices, Franchise Churning & Personal Vendettas*, BLUE MAUMAU, May 7, 2015, http://www.bluemaumau.org/7eleven_whistleblower _alleges_predatory_practices_franchise_churning_personal_vendettas.

115. *Id.*; *Franchisees Paint Grim Scenes of Dunkin'*, BLUE MAUMAU, July 13, 2011, http://www.bluemaumau.org/10538/franchisees_paint_grim_scene_dunkin.

116. Oates Article, *supra* note 7, at 185.

117. 6 R.I. Pub. Laws § 6-50-1 (2007).

118. Joseph J. Fittante, Jr., Meredith Bauer, *Defaults and Terminations: An Unfortunate Reality of A Challenging Economy*, 28 FRANCHISE L.J. 214 (2009) (noting that in 2007, Kansas and Tennessee considered, but ultimately did not pass, the Kansas Responsible Franchise Practices Act and the Tennessee Franchise Disclosure Act).

119. *See* Spandorf, *supra* note 8.

tions Act (CFRA) was amended to include significant additional protections for franchisees facing termination or nonrenewal without fair compensation for their franchised businesses.[120] Assembly Bill No. 525 addressed what the California legislature clearly found were inequities in the modern franchise relationship.[121]

In recent years, bills aimed at protecting franchisees have been introduced in state legislatures across the country, including in Florida, Maine, Massachusetts, and Pennsylvania.[122] Even though franchisor advocates and lobbyists have successfully opposed these bills and prevented their enactment, testimony in support of these bills underscores the problems that many franchisees continue to face today. Examples include:

- A franchisee wrote a letter in support of franchisee renewal rights, stating: "[p]resently Franchise Owners who adhere to brand standards and honor their obligations can only watch their equity evaporate as the end of their franchise term nears. Without reasonable assurances of renewal, our family businesses essentially become rent-a-businesses and are worthless to anyone except the Franchisor. Franchise Owners are often presented with one of two options: Sign a more draconian new

120. California Legislative Information, Assembly Bill No. 525, *available at* http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201520160AB525&search_keywords=%22Franchisee%22.

121. The bill passed with a large majority in the California legislature, 56–12 in the Assembly and 37–0 in the Senate. Michel Guta, *A Break for California Franchise Owners? New Law Gives Them More Control*, SMALL BUS. TRENDS, Nov. 2, 2017, https://smallbiztrends.com/2015/11/california-franchise-owners-assembly-bill-525.html. Chris R. Holden, one of the legislators who championed the bill, drafted a letter to the Chief Clerk of the California State Assembly to ensure the intent of the bill was clear. He stated, among other things, that: (1) owning a franchise requires significant investment and risk on the part of the franchisee—risk often not shared between franchisee and franchisor; (2) the bill was intended to ensure that terminated franchisees recoup a portion of their investment in items specific to the franchise that the franchisor can use or sell to another franchisee; (3) the bill was to protect franchisees that are forced to pay large fees for franchise assets that remain owned by the franchisor; (4) the intent of the bill was to provide a clear and transparent process for the transfer of a franchise and to prohibit franchisors from arbitrarily withholding consent to a sale when a qualified buyer is presented; and (5) it was the legislative intent that a franchisee has the legal right to obtain injunctive relief to prevent the selling or takeover of his business by a franchisor during any legal action. *See* Letter to E. Dotson Wilson from Chris R. Holden, CAL. BUS. & PROF. CODE § 20020 (West), Historical and Statutory Notes, 2017 Main Volume.

122. *See* A.B. 525, Gen. Assemb., Reg. Sess. (Cal. 2015), *available at* http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201520160AB525&search_keywords=%22Franchisee%22; H.P. 1043, L.D. 1458, 126th Gen. Assemb., Reg. Sess. (Me. 2015), *available at* http://www.mainelegislature.org/legis/bills/getPDF.asp?paper=HP1043&item=2&snum=126; S.B. 1843, 187th Gen. Assemb., Reg. Sess. (Mass. 2011), *available at* https://malegislature.gov/Bills/187/S1843; S.B. 73, 188th Gen. Assemb., Reg. Sess. (Mass. 2013), *available at* https://malegislature.gov/Bills/188/S73; S.B. 114, 189th Gen. Assemb., Reg. Sess. (Mass. 2015), *available at* https://malegislature.gov/Bills/189/S114; H.B. 1913, 201st Gen. Assemb., Reg. Sess. (Pa. 2017), *available at* http://www.legis.state.pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=PDF&sessse=2017&sessInd=0&billBody=H&billTyp=B&billNbr=1913&pn=2705; H.B. 1913, 201st Gen. Assemb., Reg. Sess. (Pa. 2017), *available at* http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2017&sessInd=0&billBody=H&billTyp=B&billNbr=1913&pn=2705.

form franchise agreement or walk away from their life's work and family's business equity."[123]

- A franchisee testifying as to franchisor abuses explained that, after he had made improvements to both of his franchised stores, his franchisor singled him out and terminated his two franchises based upon a pretext, all so the franchisor could resell his franchises at a profit.[124]
- A former franchisee, and then attorney, testified that, despite positive changes to a particular franchisor's franchise agreement, "[t]he fact is there are bad actors. That's why you need a minimal level of behavior."[125]
- A Pennsylvania legislator championing a franchise bill noted to his colleagues: "Pennsylvania is lagging behind the curve when it comes to franchise regulation. The laws in place do not do enough to protect franchisees from unfair practices in the sale and operation of franchised businesses."[126]
- Florida franchisees recently testified about the very real, common, and *current* problems and abuses franchisees face, including franchisors taking franchised businesses (and the franchisees' established goodwill) without "good cause," the devastating costs of litigation for franchisees, and the fact that nearly all franchisors require franchisees to bet their personal and family wealth on the success of the franchise venture by requiring a personal guaranty.[127]
- A representative of several franchisee associations testifying in support of franchisee protection summarized the inherent problem in franchising without state franchise laws, stating: "[franchising is the] perfect symbiotic relationship . . . unless [there is] a bad franchisor," in which case it turns "into a nightmare" for franchisees.[128]

Indeed, although certain "pro-franchisee" bills have passed and others have failed, despite any alleged "balance of information in the age of the Internet," franchisees are telling state legislatures that they rely on statutory protections at least as much today as they did in the past.

123. *Id.* at 26.

124. *Id.* This process is known as "churning," a franchisor ploy to opportunistically terminate a franchise agreement of an otherwise efficient and profitable franchisee in order to resell the franchise at a premium or to operate the profitable franchise as a company-owned outlet. Uri Benoliel & Jenny Buchan, *Franchisees' Optimism Bias and the Inefficiency of the FTC Franchise Rule*, 13 DePaul Bus. & Com. L.J. 411, 415–16 (2015).

125. *See Franchisees Paint Grim Scenes of Dunkin'*, *supra* note 115.

126. Representative Thomas P. Murt, House Co-Sponsorship Memoranda—Pennsylvania Franchise Law, Oct. 26, 2017, *available at* http://www.legis.state.pa.us//cfdocs/Legis/CSM/showMemoPublic.cfm ?chamber=H&SPick=20170&cosponId=24778 (last visited Oct. 29, 2018).

127. Florida Senate, Committee on Regulated Industries, Senate Committee Meeting, Apr. 4, 2017, *available at* http://www.flsenate.gov/media/videoplayer?EventID=2443575804_2017041034& Redirect=true (testimony beginning at 21:00).

128. *Id.*

IV. Extraterritorial Application of State Franchise Laws Does Not Violate the Dormant Commerce Clause

The Oates Article flatly asserts that some state franchise statutes "raise constitutional issues" and that courts have not properly addressed what interest a state may have in regulating the sale or operation of franchises not owned by their residents or operated in their state.[129] The authors of this article believe neither assertion is true.

The U.S. Constitution grants Congress the power to "regulate commerce . . . among the several States."[130] Courts recognize "that this affirmative grant of authority also encompasses an implicit or dormant limitation on the authority of states to enact legislation affecting interstate commerce."[131] The Commerce Clause reflects "the Constitution's special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and the autonomy of the individual states within their respective spheres."[132]

A court analyzing a Commerce Clause challenge applies two tiers of scrutiny: a "discrimination" tier and an "undue burden" tier. Under the discrimination tier, "when a statute clearly discriminates against interstate commerce," either on its face or in its effect, "it will be struck down unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism."[133] Such statutes are *per se* invalid.[134] Under the undue burden tier, the court will uphold statutes that "regulate evenhandedly to effectuate a legitimate local public interest" and have "only incidental effects" on interstate commerce unless the party challenging the statute can show that the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.[135]

In the franchise arena, courts have unanimously rejected franchisor challenges to state franchise statutes under the discrimination tier.[136] Courts have held that franchise statutes are facially neutral in that they regulate both resident franchisors and foreign franchisors, and franchisors have been unable to prove a discriminatory effect on interstate commerce.

A. *State Franchise Statutes Are Not Unconstitutionally Extraterritorial*

Although state laws that have "the practical effect of regulating commerce occurring wholly outside the state's borders" are invalid under the Com-

129. Oates Article, *supra* note 7, at 213.
130. U.S. CONST. art. I § 8, cl.3.
131. Healy v. Beer Inst., 491 U.S. 324, 326 n.1 (1989).
132. *Id.* at 335–36.
133. Wyoming v. Oklahoma, 502 U.S. 437, 454–55 (1992).
134. Instructional Sys., Inc. v. Computer Curriculum Corp., 35 F.3d 813, 824 (3d Cir. 1994).
135. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).
136. *See* Yamaha Motor Corp., USA v. Jim's Motorcycle, Inc., 401 F.3d 560 (4th Cir. 2005); *see also* Int'l Franchise Ass'n, Inc. v. City of Seattle, 97 F. Supp. 3d 1256, 1268–69 (W.D. Wash. 2015).

merce Clause,[137] not every law that has some measurable out-of-state impact violates the Commerce Clause. As the court in *Instructional Systems v. Computer Curriculum* noted, "it is inevitable that that a state's law . . . will have extraterritorial effects."[138] Courts "never suggested that the Dormant Commerce Clause requires Balkanization, with each state's laws stopping at the border."[139] Although some state franchise statutes affect franchise relationships in other states, they do not, as the Oates Article suggests, "raise constitutional issues."[140]

To determine whether a state's legislation has an impermissible extraterritorial effect, courts focus on the applicability and effects of the statute as well as the risk of inconsistent legislation between different states. In *Healy v. Beer Institute*, Justice Blackmun summarized the Court's approach to extraterritoriality: "taken together our cases . . . stand at a minimum for . . . three propositions."[141] First, the Commerce Clause "precludes the application of a state statute to commerce that takes place *wholly* outside of the State's borders."[142] Second, a statute that "directly controls commerce occurring *wholly* outside the boundaries of a State exceeds the inherent limits of the enacting State's authority and is invalid regardless of whether the statute's extraterritorial reach was intended."[143] The reviewing court will inquire "whether the practical effect of the regulation is to control conduct beyond the boundaries of the state."[144] Third, any assessment of the "practical effect" of a statute must consider "how the challenged statute may interact with the regulatory schemes of other states," including what the effect would be if "many or every State adopted similar legislation."[145] A statute that violates any of the propositions is *per se* invalid.

1. State Franchise Statutes Do Not Apply to Conduct Wholly Outside State Borders

The Oates Article argues that courts have generally invalidated state franchise statutes that apply to non-resident franchisees operating in other states as violations of the Commerce Clause because they require "non-residents to obtain the approval of the regulating state before they can implement spe-

137. *Healy*, 491 U.S. 324, 336–37.
138. 35 F.3d 813, 826 (3d Cir. 1994).
139. *Id.*
140. Oates Article, *supra* note 7, at 212. Although issues of extraterritoriality could be discussed in the context of other constitutional provisions such as the Full-Faith-and-Credit Clause, courts typically "treated extraterritoriality, when it has arisen in the context of a dormant commerce clause case, as if it were a dormant commerce clause problem." *Instructional Sys.*, 35 F.3d at 824 n.17.
141. 491 U.S. at 336 (1989).
142. *Id.; see also* Edgar v. MITE Corp., 457 U.S. 624, 642–43 (1982) (emphasis added); Brown-Forman Distillers Corp. v. New York State Liquor Auth., 476 U.S. 573 (1986).
143. *Healy*, 491 U.S. at 337.
144. *Brown-Foreman*, 476 U.S. at 579.
145. *Id.*

cific business practices elsewhere."[146] This analysis ignores the fact that even the "broadest" of state franchise statutes apply "only when an important aspect of the franchise transaction," such as an offer to sell or buy, acceptance of the offer, or the actual sale occurs in the regulating state.[147,148]

Under Justice Blackmun's analysis in *Healy*, a statute's extraterritorial reach is void only if it applies to conduct that occurs *wholly* outside the enacting state's borders. *Healy*, for example, struck down a liquor pricing statute that attempted to regulate the price of alcohol in other states.[149] Similarly in *Edgar v. MITE Corp.*, the U.S. Supreme Court struck down a statute that required state regulators to approve corporate takeover offers, even if such offers would affect no Illinois shareholders.[150]

However, a statute that applies to conduct that occurs both inside and outside of the state is permissible. Thus, in *Instructional Systems v. Computer Curriculum Corp.*, the court rejected a challenge to the extraterritorial application of the New Jersey Franchise Practices Act, holding that a franchisee who was a party to a multi-state franchise agreement could assert claims under the Act (even though several of the franchise outlets were located outside of New Jersey) because the franchisee had a location in New Jersey.[151] Similarly, in *Mon-shore Management, Inc. v. Family Media Inc.*, the court held that the New York Franchise Sales Act did not violate the Dormant Commerce Clause by regulating the sales of franchises in circumstances "where the offer originates, is extended or is accepted in New York."[152] In that case, the court explained that "while the primary thrust of the [Franchise] Act was full disclosure," it also attempted to "forge a comprehensive legal structure to thwart, combat, and rectify franchise sales abuses."[153] The court pointed to the legislative finding of the Act stating that "New York has a valid interest in protecting franchisees from unscrupulous franchisors" and noted that by extending the Act's protection to franchisees in other states, as long as the offer or acceptance took place in New York State, the legislature was acting not only to protect franchisees but also to "protect

146. Oates, *supra* note 7, at 212.

147. Mon-Shore Mgmt., Inc. v. Family Media, Inc., 584 F. Supp. 186 (S.D.N.Y 1984).

148. The Oates Article relies on a parade of horribles to bolster its claim that state franchise statutes pose a risk of extraterritorial application, noting that that it is "troubling . . . that courts in New York and Florida are willing to impose their state's franchise statutes even when there have been no contacts with the state other than a choice of law provision." Oates, *supra* note 7, at 213. The Oates Article fails to cite any cases to support its concern. In fact, courts have repeatedly held that a franchisee may not make claims under a state's franchise statute when the franchisee had no contact with the state even when the parties agree that law of the state applies. *See* Taylor v. 1-800-Got-Junk?, LLC, 632 F. Supp. 2d 1048 (W.D. Wash. 2009); Cromeens Holloman, Sibert, Inc., v. AB Volvo, 349 F.3d 376, 386 (7th Cir. 2003). Even New York courts have reached that conclusion. *See* Peugeot Motors of Am., Inc. v. E. Auto Distrib., Inc., 892 F.2d 355, 358 (4th Cir. 1989).

149. *Healy*, 491 U.S. at 337.

150. 457 U.S. 624 (1982).

151. *Instructional Sys.*, 35 F.3d at 826.

152. *Mon-Shore Mgmt.*, 584 F. Supp. at 189–90.

153. *Id.* at 189.

and enhance the reputation of the State, which is in and of itself, a legitimate and substantial state interest."[154]

Indeed, it would be nonsensical, for example, for Minnesota to discourage franchise sales abuses by enacting a law that protected Minnesota residents from all unscrupulous franchisors, but allowed franchisors, Minnesota-based or foreign, to engage freely in franchise sales abuses in Minnesota as long as their victims are non-residents.

The Oates Article argues that the decision in *Mon-Shore* "contradict[s] the more sound reasoning of the U.S. Supreme Court in *Edgar v. MITE Corp*."[155] This is not true. The *Mon-Shore* court extensively discussed and distinguished *Edgar*, noting that "while superficially appealing," the "analogy between [the statute at issue in *Edgar*]" and New York's Franchise Sales Act "is inapposite."[156] In *Edgar*, the Supreme Court held that the statute violated the Dormant Commerce Clause because the challenged statute could have "permanently thwarted" a nationwide tender offer from a non-resident actor even if none of its resident shareholders were affected by the offer, and that the State of Illinois has no legitimate interest in protecting non-resident shareholders in out-of-state transactions.[157] Conversely, in *Mon-shore*, the regulated transaction, the sale of a franchise, occurred within the boundaries of the regulating state. *Mon-Shore* and later courts have repeatedly held that state franchise laws generally do not regulate extraterritorially because each statute "only becomes operative when an important aspect of the franchise relationship" occurs within the state.[158] The authors believe the Oates Article unreasonably narrows the meaning of the word "commerce" by focusing exclusively on the residence of the franchisee or the location of the franchise, removing the entire franchise sales process from the equation.

In addition to ignoring key differences between the challenged statute in *Edgar* and state franchise laws, the Oates Article fails to mention a distinguishing factor—that the challenged Illinois statute was preempted by federal legislation and that the state statute conflicted with federal law.[159] The same is not true with franchise law. Under the FTC Rule, states are not only explicitly empowered to enact statutes that provide greater protection, they are encouraged to do so.[160] The Oates Article's comparison between the statute in *Edgar* and state franchise statutes would be valid only if the FTC removed the FTC Franchise Rule language empowering states to enact broader franchise legislation, and if state franchises statutes applied to all franchise transactions irrespective of the residence of the franchisor, the franchisee, the franchise outlet, and the location(s) of the transaction.

154. *Id.* at 191–92.
155. Oates, *supra* note 7, at 213.
156. *Mon-Shore Mgmt.*, 584 F. Supp. at 190.
157. *Edgar*, 457 U.S. at 642–43.
158. *Mon-Shore Mgmt.*, 584 F. Supp. at 191.
159. *Edgar*, 457 U.S. at 640.
160. 16 C.F.R. § 436, n.2.

A state franchise statute in Kentucky regulating sales made in Nevada by a Georgia franchisor would probably violate the Dormant Commerce Clause.

2. State Franchise Statutes Do Not Affect Commerce Wholly Outside State Borders

Franchisors have also argued that franchise statutes are unconstitutional because they have extraterritorial effects. Again, this misrepresents the actual legal standard. A statute that regulates extraterritorially is *per se* invalid only if it "directly controls commerce occurring *wholly* outside the boundaries of a State."[161] Thus, *in Volvo Trademark Holding Aktiebologet v. AIS Construction Equipmen*t, the court held that the Arkansas Unfair Trade Practices Act was not *per se* invalid because "at least one end [of the transaction] must be in Arkansas" and therefore the statute could not regulate "commerce occurring wholly outside Arkansas."[162]

The Oates Article argues that "courts have not properly addressed what interest, if any, states have in regulating franchises" that are not located in or operated by residents of the regulating states.[163] A cursory review of the case law demonstrates this is not true. Several courts have discussed why legislatures may choose to regulate franchises that are sold but not located in their state. In *Mon-Shore Management*, discussed earlier, the court noted that the New York legislature "did not attempt to protect only the residents of this State," but by extending the protections of the Act to franchisees who received or accepted an offer in New York, the legislature acted to "protect and enhance the commercial reputation of the State itself."[164] Similarly, in *Red Lion Hotels Franchising, Inc., v. MAK, LLC*,[165] the court noted that "it was easy to see why the Washington legislature might have wanted to apply" the Washington franchise statute's relationship provisions to nonresident franchisees of a Washington franchisor: "the legislature might have wanted to reassure potential out-of-state franchisees that they would be treated fairly by, and thereby encourage them to do business with, Washington franchisors."[166]

Several franchise statutes expressly apply to a franchise "offered" or "sold" "in this state."[167] It is difficult to imagine that, despite this plain language,

161. *Healy*, 491 U.S. at 336.
162. Volvo Trademark Holding Aktiebolaget v. AIS Constr. Co., 416 F. Supp. 2d 404 (W.D.N.C. 2006).
163. Oates Article, *supra* note 7, at 213.
164. *Mon-Shore Mgmt.*, 584 F. Supp. at 191.
165. 663 F.3d 1080 (9th Cir. 2011).
166. *Id.* at 1091.
167. *See* CAL. CORP. CODE § 31013 (1971); R.I. GEN. LAWS § 19-28.1–4 (1993); OR. REV. STAT. § 650.015 (1973); MICH. COMP. LAWS § 445.1507a (1989); N.D. CENT. CODE § 51-19-02(14)(b) (1993); WASH. REV. CODE § 19.100.020 (2012); MINN. STAT. § 80C.03 (1986); WIS. STAT. § 553.21 (2017); 815 ILL. COMP. STAT. 705/3(20) (2009); S.D. CODIFIED LAWS § 37-5B-2 (2008); MD. CODE ANN., BUS. REG. § 14-203(a) (1992).

state legislators would permit fraudulent activity by in-state franchisors merely because the franchisee victims are out-of-state.[168]

3. State Franchise Statutes Do Not Pose a Risk of Inconsistent Legislation

Finally, franchisors have argued that the state franchise statutes violate the Dormant Commerce Clause because they subject franchisors to inconsistent state regulations. However, "state laws which merely create additional, but not irreconcilable, obligations" are not considered to be "inconsistent" for the purpose of a Dormant Commerce Clause challenge.[169] The party challenging the law bears the burden of demonstrating that the challenged statute creates "actual conflict amongst state regulations."[170] Thus, in *Instructional Systems, Inc., v. Computer Curriculum Corp.*, the court concluded that the New Jersey Franchise Protection Act's limitations on terminations were not *per se* invalid because "while the laws of other states might permit [the franchisor] to conduct its franchise relationship with [the franchisee] under a different framework than the one required by NJFPA, that difference in approach by different states is not sufficient to require *per se* invalidation."[171] The court explained that state franchise statutes that require the franchisor to register prior to selling franchises or which require additional disclosures would also not be *per se* violations.[172]

Applying the principle that a state law is not *per se* invalid unless it would create "actual conflict among state regulations," it is clear that state franchise registration statutes are not unconstitutionally extraterritorial. The mere fact that something may be subject to stricter sale requirements in one state than in another does not violate the Dormant Commerce Clause. For example, the fact that a gun seller may have to comply with stricter regulations to sell a gun in the state of Washington than in Texas (regardless of which state the gun purchaser resides in) does not violate the Dormant Commerce Clause. If states were to enact legislation that imposed no more regulations than the least restrictive state, states would cease to be "laboratories of democracy" and would instead become participants in a race to the bottom in which the state with the least regulations would set the standard for the nation.

If state franchise statutes truly burdened interstate commerce, one would expect to see some impact on the franchise economy in the states with the

168. *See, e.g.*, Dollar Sys., Inc. v. Avcar Leasing Sys., Inc., 890 F.2d 165, 171 (9th Cir. 1989) (correctly holding that the California Franchise Investment Law applied to a franchise agreement negotiated and executed in California, even though franchise was purchased by nonresidents and operated in the Virginia–Maryland–D.C. area).

169. *Instructional Sys.*, 35 F.3d at 826 (quoting Buzzard v. Roadrunner Trucking, 966 F.2d 777, 784 n.9 (3d Cir. 1992)).

170. *Id.* (quoting Old Bridge Chems., Inc. v. New Jersey Dep't of Envt'l Prot., 965 F.2d 1287, 1293 (3d Cir. 1992)).

171. *Id.* at 826.

172. *Id.*

broadest regulations. The data does not support this conclusion. Florida and New York have franchise statutes specifically criticized by the Oates Article. Their franchise economies are booming. In New York, there are more than 29,000 franchise outlets and the International Franchise Association predicts that number will grow by 1.3 percent in 2018.[173] Similarly, in Florida there are more than 48,000 franchise outlets and the IFA predicts that number will grow by almost 3 percent in 2018.[174] The IFA also ranked Florida as one of the top five states for franchise employment growth in 2017.[175]

B. *State Franchise Laws Do Not Pose an Undue Burden on Interstate Commerce*

State franchise statutes have not only survived decades of judicial scrutiny under the "anti-discrimination" tier of Dormant Commerce Clause litigation, they have also withstood challenges to their constitutionality under the "undue burden" tier. With one exception, state franchise statutes have passed the balancing test enunciated in *Pike v. Bruce Church*, in which the U.S. Supreme Court explained that, when a statute addresses a "legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."[176] Every court evaluating state franchise statutes has held that states have a legitimate interest in (1) "encouraging full disclosure . . . and prohibiting fraud,"[177] (2) curbing "franchise sales abuses and unfair competitive practices,"[178] and (3) "addressing the disparity in bargaining power"[179] between franchisors and their franchisees.

Courts have broadly rejected franchisor claims that state statutes which require registration or which regulate aspects of the franchise relationship (1) "impose a straightjacket on" a franchisor's operations, (2) "ultimately harm the consumers by prohibiting the creation of an efficient distribution system," or (3) place an "onerous" burden on franchisors by imposing detailed disclosure and record keeping requirements.[180] As the court noted in *Instructional Systems*, "even assuming this to be true," a statute may be invalidated under *Pike* only if it "imposes a discriminatory burden on interstate commerce."[181] A statute that evenhandedly imposes a burden on all com-

173. International Franchise Association, https://franchiseeconomy.com/NY.html (last visited Feb. 1, 2018).

174. International Franchise Association, https://franchiseeconomy.com/FL.html (last visited Feb. 1, 2018).

175. Kate Roger, *Here's Where America's billion-dollar franchising industry is growing fastest*, CNBC (Jan. 24, 2017, 4:13 P.M.), https://www.cnbc.com/2017/01/24/heres-where-americas-franchising-industry-is-growing-fastest.html.

176. *Pike*, 397 U.S. at 142.

177. *Mon-Shore Mgmt.*, 584 F. Supp. at 192.

178. Morris v. Int'l Yogurt, Co., 729 P.2d 33 (Wash. 1986).

179. Yamaha Motor Corp., USA v. Jim's Motorcycle, Inc., 401 F.3d 560 (4th Cir. 2005).

180. *Instructional Sys.*, 35 F.3d at 827.

181. *Id.*

merce is generally constitutional. In the single case where a court has invalidated a portion of a franchise statute under the *Pike* test, the court noted the challenged portion "had no parallel in the law of any other state" and imposed "heavy burdens on out of state interest" and that the challenged section offered no benefits to a state interest beyond those offered by other sections of the statute.[182]

VI. Conclusion

To borrow from Mark Twain, the Oates Article's report about the death of the need for state franchise regulation is an exaggeration. State franchise laws that protect the interests of franchisees and discourage unscrupulous franchisors remain necessary. Franchisees are still significantly less experienced and sophisticated than franchisors. The vast majority of franchisees have never operated their own business and do not have independent counsel advising them. Franchise agreements are frequently presented as "take it or leave it" propositions, and the franchisor retains significantly more power than the franchisee in managing the relationship.[183] Accordingly, more than a dozen states have enacted specific statutes regulating both franchise sales and the franchise relationship. Rather than being the relic of a dark time, many states have either amended their statutes to broaden their protection or have considered doing so.

Finally, the differences between these statutes and their extraterritorial application are not unconstitutional. Rather, these statutes are the embodiment of the federalist system in which each state acts to protect its residents from unscrupulous businesses and prohibit its businesses from behaving unscrupulously. The Oates Article implies that these states should instead surrender that decision-making authority to the federal government by relying exclusively on the FTC Rule, which does not even allow for private right of action. This conclusion not only contracts the FTC Rule itself, but it is antithetical to our entire system of government. State legislatures should be encouraged to continue looking for better ways to protect franchisees and encourage fair and equitable franchise practices through franchise legislation.

182. *Id.* at 570–71.

183. The implied theory in the Oates Article that franchisees have become so sophisticated that they have "outgrown" the need for state statutory protection is questionable. Even if true, however, the franchisor's viewpoint is moot because there are exemptions at the state and federal levels that exclude large, sophisticated franchisees from statutory protection. *See* 16 C.F.R. § 436.8(a)(5)(i) ("large investment" exemption for franchise investments totaling more than $1,143,100); 16 C.F.R. § 436.8(a)(6) ("large franchisee" exemption for franchisees in business for at least five years and a net worth of at least $5,715,500). Certain states have crafted similar exemptions to their franchise laws. *See, e.g.*, ILL. ADMIN. CODE tit.14, § 200.201(c) ("large investment" exemption); MD. CODE REGS. 02.02.08.10(E)(1) (same); S.D. Franchise Investment Act § 13(1) (same); WIS. STAT. § 553.235(1)(a) (same); CAL. CORP. CODE § 31109 ("large franchisee" exemption); 815 ILL. COMP. STAT. 705/8(a)(2) (same); R.I. GEN. LAWS § 19-28.1-6(4) (same); S.D. CODIFIED LAWS § 37-5B-13(2) (same); WASH. REV. CODE § 19.100.030(5) (same); WIS. STAT. § 553.235 (same).

Appendix A
Results of Franchisee Survey (253 Respondents)

Table 1
An attorney reviewed my franchise agreement, franchise disclosure document (FDD), and/or Uniform Franchise Offering Circular (UFOC) before I purchased my first franchise.

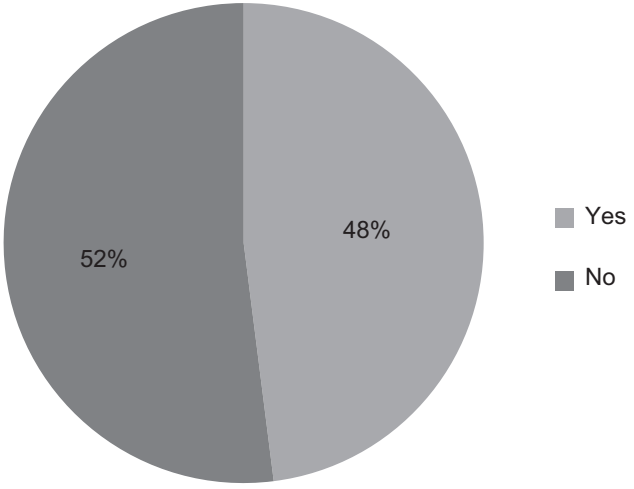

Table 2
During the franchise sales process, my franchisor's salesperson told me that I could hire an attorney to review my franchise agreement.

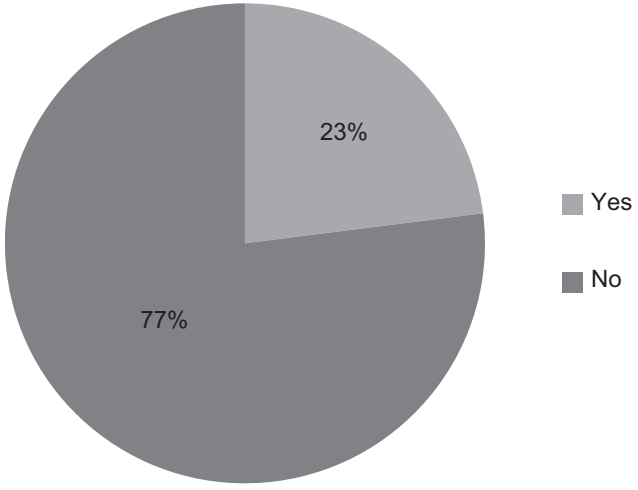

Table 3
During the franchise sales process, my franchisor's salesperson told me that my franchisor would not make any changes to the franchise agreement.

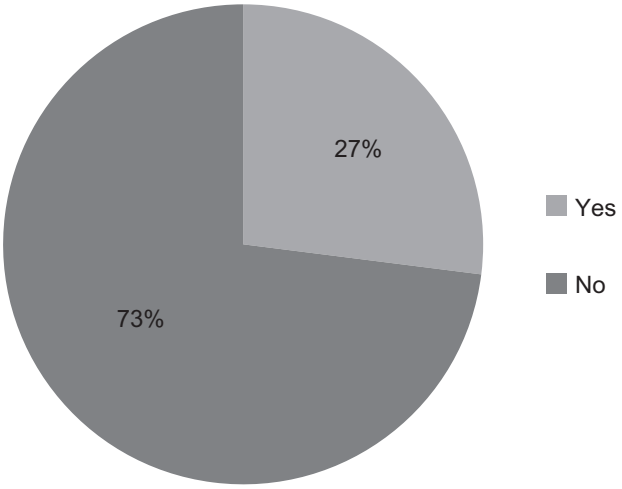

Table 4
Number of franchise units owned by franchisee respondents.

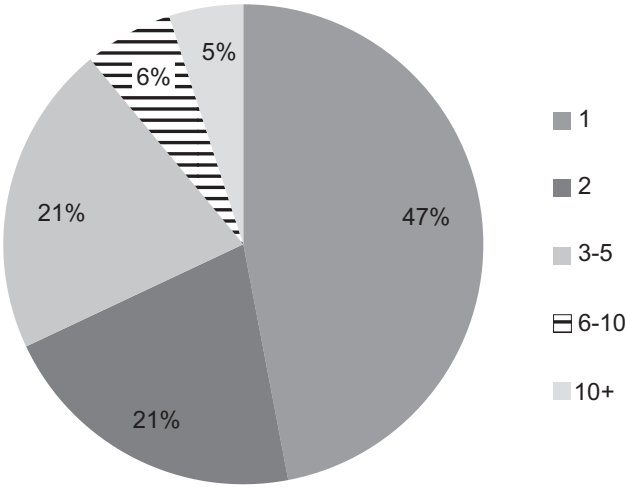

Exhibit E

Table 5
The franchise disclosure document (FDD) (or Uniform Franchise Offering Circular (UFOC)) I received was an accurate and complete description on my franchise investment.

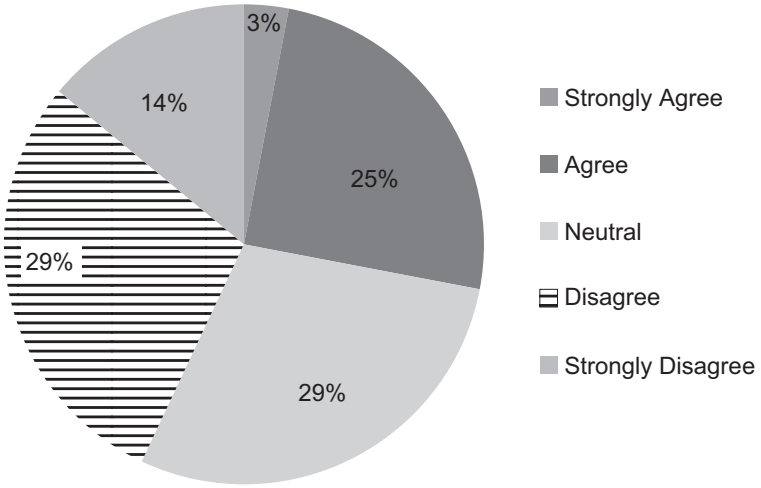

Table 6
During the franchise sales process, my franchisor's salesperson made statements related to sales, costs, and profits that were not included in the FDD or UFOC.

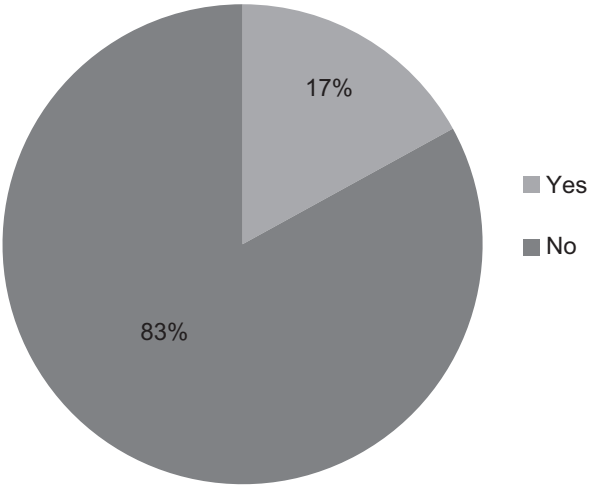

Exhibit E

Petition for Investigation of the Franchise Industry

Submitted by:

Service Employees International Union

Exhibit D

The Service Employees International Union (the "petitioner") hereby petitions the Federal Trade Commission ("FTC") to investigate the franchise industry to determine the existence and extent of abusive and predatory practices by franchisors toward franchisees. The petitioner requests that the FTC issue an order pursuant to FTC Act section 6(b) to no fewer than nine leading franchise companies compelling the production of information about those companies' relationships with their franchisees. Upon completion of the FTC's investigation, the petitioner requests that the FTC issue a report detailing the extent of abusive franchisor practices and recommending ways to curb these practices in the future.

This petition describes the franchisor practices that the petitioner believes are most harmful to franchisees and most endemic to the relationship. They are: (1) incomplete or misleading financial performance representations made to prospective franchisees by franchisors; (2) significant capital investments required by franchisees during the course of the franchise agreement or as a condition of renewal; (3) retaliation against franchisees that join franchisee associations; (4) unfair termination or nonrenewal of franchise agreements; and (5) arbitrary denial of franchisees' requests to transfer the business.

Section I of the petition describes the petitioner. Section II describes the profound imbalance of power in the franchise relationship and how the one-sided franchise agreement frequently capitalizes on this imbalance. Section III explains each of the predatory franchisor practices listed above, providing examples of franchisors that engaged in these practices, and explains how these practices harm franchisees. Some of the practices appear to violate the Commission's existing Franchise Rule, while others appear to violate section 5's prohibition against unfair and deceptive practices. Section IV requests that the FTC, pursuant to section 6(b) of the FTC Act, undertake an investigation of abusive practices in the franchise industry and issue recommendations on how to prevent these abuses in the future.

I. Petitioner

The Service Employees International Union ("SEIU") is an organization of more than two million members and is a leading advocate for working people.

II. The franchise relationship is characterized by a dramatic imbalance of power.

Franchised businesses represent a large and growing segment of the nation's businesses, making up almost 11 percent of businesses with employees,[1] employing an estimated 9.1 million people,[2] and consistently adding jobs faster than non-franchised businesses in recent years.[3] Yet, unlike traditional small businesses, most franchises reflect a profound imbalance of contractual power that favors the franchisor and places franchisees in a financially precarious situation.

Companies that market and sell franchises are professional operations with access to legal advice, finance professionals, and – in most cases – capital markets. In contrast, prospective franchisees are often unsophisticated parties that lack bargaining power and have invested their life savings in the franchise, which makes them susceptible to predatory practices by franchisors.[4] The lack of business sophistication is documented in a March 2015 survey of 1,122 franchisees nationwide conducted by FranchiseGrade.com, Inc., a leading provider of competitive market research and objective analysis for the franchise industry.[5] The poll was commissioned by Change to Win, a federation of labor unions that includes petitioning organization SEIU. According to the survey, 63 percent of franchisee respondents had never owned any type of business before investing in their current franchise system.[6] Further, 69 percent of franchisee respondents had no

[1] U.S. Census Bureau, *Census Bureau's First Release of Comprehensive Franchise Data Shows Franchises Make Up More Than 10 Percent of Employer Businesses*, Sept. 20, 2010, http://www.census.gov/newsroom/releases/archives/economic_census/cb10-141.html.
[2] PricewaterhouseCoopers LLP, *The Economic Impact of Franchised Business: Volume III, Results for 2007*, Feb. 7, 2011, http://www.buildingopportunity.com/download/Part1.pdf.
[3] Int'l Franchise Assoc., Franchise Industry Continues to Grow, http://franchiseeconomy.com/franchise-industry-continues-to-grow/ (last visited May 4, 2015).
[4] Franchisees are much more similar to consumers than sophisticated business operators and are thus deserving of a level of regulatory attention commensurate to that afforded consumers. For example, the FTC bars lenders from including various unfair credit practices in their contracts; bars certain funeral contract terms; and mandates a cooling off period in consumer contracts with door-to-door salespeople, among other protections.
[5] FranchiseGrade.com, *National Survey of Franchisees 2015*, enclosed as Appendix 3.
[6] *Id.* at 9.

management experience in the industry or sector in which their franchise system operates.[7]

This survey supports the findings of prior academic studies that revealed similar levels of franchisee inexperience and lack of resources. These academic studies paint a picture of an industry in which one party operates with significant disadvantages:

- Most franchisees have never owned a business. One study found that only 20 percent of franchisees had been business owners prior to their purchase of a franchise.[8]
- The majority of franchisees have never even worked in the same line of business as their franchise. One study found that 70 percent of franchisees "purchased franchises in business sectors in which they had no specific work experience."[9] Another study found that 62 percent of franchisees had not worked in the same business as their franchise.[10]
- Many franchisees do not consult with an attorney before signing a franchise agreement:
    - A 2014 survey of franchisor attorneys found that a barely one-fourth (26 percent) of franchisees were represented by an attorney at the signing of their franchise agreement. Furthermore, the franchisor attorneys commented that, when franchisees did have attorneys, they were often general practitioners rather than specialists in franchising.[11]
    - A survey of over 300 franchisees in several industries found that most did not consult an attorney before signing. The same survey also found that most

[7] *Id.* at 10.
[8] Kimberly A. Morrison, *An Empirical Test of a Model of Franchisee Job Satisfaction*, 34 J. SMALL BUS. MGMT. 27, 30 (1996).
[9] Patrick J. Kaufmann, *Franchising and the Choice of Self-Employment,* 14 J. BUS. VENTURING 345, 358 (1999).
[10] Robert L. Anderson et al., *Are Franchisees 'Real' Entrepreneurs?*, 4 J. BUS. & ENTREPRENEURSHIP 97, 100-101 (1992).
[11] Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether To Hire Counsel*, 51 SAN DIEGO L. REV. 709, 718-719 (2014).

franchisees did not review the Uniform Franchise Offering Circular, the predecessor to the FDD, before investing in a franchise.[12]

Once they purchase a franchise business, franchisees typically remain small businesses. According to nationally-recognized franchising data sources FranDATA and Franchise Business Review, 81 percent of franchisees own only one unit, and the median income of franchisees is $50,000-$75,000 a year.[13] According to the March 2015 survey of franchisees, 41% of respondents indicated a combined salary and profit of less than $25,000.[14] Franchisors, by contrast, are often large corporations with resources dwarfing that of prospective franchisees. The top 25 franchise systems, by unit count, account for 21 percent of all franchised units in the country[15] and take in a combined $52 billion in revenue.[16]

Moreover, some franchisors specifically market to unsophisticated investors, such as the unemployed, retirees, or immigrants.[17] As Stephen Caldeira, who heads the International Franchise Association, a franchisor-dominated trade group, stated, "For those Americans dealing with long-term unemployment or a lack of growth opportunities in their current jobs, franchise ownership offers a viable way to be in business for yourself, but not by yourself."[18]

Some franchise systems advertise the lack of sophistication required of potential investors. A search of a leading franchise advertising site, FranchiseGator.com, turned up numerous advertisements with language aimed at inexperienced potential entrepreneurs, including these:

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[12] Morrison, *supra* note 8, at 30-31.
[13] Elizabeth Garone, *The New Face of Franchisees*, WALL ST. J., Aug. 19, 2013, *available at* http://online.wsj.com/news/articles/SB10001424127887324021104578553580349491440.
[14] Appendix 3, *supra* note 5, at 26.
[15] PricewaterhouseCoopers LLP, *supra* note 2, at I-20-21.
[16] The revenue data was compiled from each company's FDD and SEC Form 10-K or business publication estimates if there were no SEC filings.
[17] Angus Loten, *Franchises Target Immigrants as Buyers*, WALL ST. J., Feb. 3, 2014, *available at* http://online.wsj.com/news/articles/SB10001424052702303465004579324104108839042; Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship,* 109 PENN STATE L. REV. 105, 153 (2004).
[18] Matthew Haller & Jenna Weisbord, *December Jobs Report Mirrors Growth Sectors for Franchising in 2013*, Int'l Franchise Assoc., Jan. 4, 2013, http://www.franchise.org/december-jobs-report-mirrors-growth-sectors-for-franchising-in-2013.

- "There's no cooking or frying involved and no experience necessary,"[19] claimed an ad seeking franchisees for the shrinking[20] Blimpie sandwich chain.
- "No experience necessary — we provide full training . . . You do not need to be a CPA, or possess prior tax industry experience to be considered for a Jackson Hewitt franchise."[21]
- "**No experience is needed!** . . . HouseMaster provides you with a turnkey system that is sustainable and scalable, allowing you to grow your business quickly,"[22] claimed an advertisement for a home inspection franchise.

The lack of sophistication is particularly problematic when one considers the complex and lengthy disclosures made to prospective franchisees so that they can ostensibly gauge the financial and other risks associated with purchasing the franchise. The franchise disclosure document ("FDD"), which the Franchise Rule requires franchisors to provide to prospective franchisees at least 14 calendar days before signing the agreement, is the primary source of information about the risks and rewards of purchasing a particular franchise. FDDs contain hundreds of pages of financial and legal information about the franchisor as well as the parties' respective obligations. They are dense and technical documents, making thorough review and understanding difficult for unsophisticated investors, such as the typical franchisee.[23] Crucially, *not* included in the FDD is the franchisor's full operations manual that often lays out in minute detail mandatory operating procedures whose violation can cost franchisees their businesses. The FTC requires franchisors to include only the table of contents of their operating manuals even though franchisors often incorporate their entire manuals by reference in their franchise agreements.[24]

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[19] FranchiseGator.com, Blimpie web ad, http://www.franchisegator.com/blimpie-franchise/ (last visited Apr. 29, 2015).
[20] Outlook, 24 RESTAURANT FINANCE MONITOR 9, 6-8, Sept. 18, 2013, http://web.tmcapital.com/tmc/news/RFM_TM_Capital_Advises_Goldco_on_Acquisition.pdf.
[21] FranchiseGator.com, Jackson-Hewitt Tax Service web ad, http://www.franchisegator.com/jackson-hewitt-tax-service-franchise/ (last visited Apr. 29, 2015).
[22] FranchiseGator.com, HouseMaster Home Inspection web ad, http://www.franchisegator.com/housemaster-home-inspection-franchise/ (last visited Apr. 29, 2015).
[23] The typical franchise disclosure document is massive, averaging nearly 500 pages for the set of 14 leading franchise systems reviewed during petitioner's contract analysis.
[24] 16 C.F.R. § 436.5(k)(6) (2007).

Even more troubling is that franchisors often reserve the right to unilaterally change the terms of the operating manuals during the term of the franchise, effectively requiring prospective franchisees to agree to terms they have not seen and that may change at any time. The March 2015 survey of franchisees found that 75 percent had experienced changes in manuals or procedures that increased their operating costs without an offsetting revenue increase.[25] Thus, even if prospective franchisees conduct a thorough review of multiple FDDs, it would be of limited use because the FDDs fail to include the full terms of the franchise.

The profound imbalance in bargaining power is reflected in the terms of franchise contracts, which are drafted to give franchisors the advantage. According to one franchisor advisory firm, franchise agreements are understood by franchising lawyers to be similar to adhesion contracts.[26] A franchisee consultant website emphasizes that franchisors usually state that they have a "rigid" franchise agreement and are "not open to negotiating."[27]

The petitioner reviewed the FDDs, including the franchise agreements, of the top ten business format franchisors by unit count. To ensure representation of significantly franchised industries not represented in the top ten, the petitioner also reviewed the FDDs for any franchise systems that did not make the top ten but were either first or second in unit count among the five sectors where franchised units make the largest contribution to employment, according to the International Franchise Association. This resulted in a set of 14 franchise systems[28] with a total of over 94,000 franchised units, representing nearly

[25] Appendix 3, *supra* note 5, at 21.
[26] MSAWorldwide.com, Negotiating Franchise Agreements – Are the Terms Fixed in Stone?, http://www.msaworldwide.com/Negotiating-agreements.pdf (last visited May 4, 2015).
[27] FranchiseHelp.com, What To Negotiate in the Franchise Agreement, Oct. 15, 2011, https://www.franchisehelp.com/blog/what-to-negotiate-in-the-franchise-agreement/ (last visited May 4, 2015).
[28] These criteria resulted in the inclusion of the following 14 franchise systems in the analysis: sandwich chain Subway, hamburger chains McDonald's and Burger King, fitness franchisor Jazzercise, coffee-snack chain Dunkin' Donuts, convenience store franchisor 7-Eleven, pizza chain Pizza Hut, tax preparation franchisor Jackson Hewitt Tax Service, financial services provider Ameriprise Financial Services, Mexican style fast food chain Taco Bell, salon franchisor Great Clips, hotel chains Holiday Inn and Comfort Inn, and casual dining chain Applebee's Neighborhood Grill & Bar. *See* Appendix 1.

14 percent of the franchised units in the country.[29] The contract analysis revealed that the contracts are strikingly similar and one-sided; all of them grant franchisors broad termination rights while affording franchisees few to no rights to renew or sell their franchise. Key results of the review are summarized and tabulated below.

[29] The 14 systems reviewed had 94,293 franchised units, according to their 2014 franchise disclosure documents. This works out to 13.9 percent of the country's 679,945 franchisee-owned business-format franchise units. *See* PricewaterhouseCoopers LLP, *supra* note 2, at I-20.

Summary of key contract provisions, 14 leading franchise systems

				Franchisor may terminate for:			Renewal restrictions:			Transfer/sale restrictions:				
Franchisor	**Some post-termination/ expiration noncompete provisions**	**Unrestricted right to inspect franchisee premises**	**Franchisor can unilaterally change manual/ procedures**	***Any* violation cause for termination ?**	**Failure to meet franchisor operating standards/ manuals/ procedures**	**Disparagement / behavior reflecting badly on franchisor**	**No renewal rights at all?**	**Renewal may be materially diff from current contract?**	**General release of franchisor required for renewal**	**Broad franchisor discretion to deny transfers/ sales**	**General release of franchisor required for transfer**	**Current franchisee violations can bar transfer**	**Remodel required for transfer**	**Franchisee retains some liability after transfer**
7-Eleven	X	X	X	X	X	X		X	X	X	X	X		
Ameriprise Financial Services	X	X	X	X	X	X		X		X	X	X		
Applebee's Neighborhood Grill & Bar		X	X	X	X	X		X		X	X			
Burger King	X	X	X	X	X			X	X	X	X			X
Comfort Inn		X	X	X	X	X	X							
Dunkin' Donuts	X	X	X	X	X	X		X	X		X	X		
Great Clips	X	X	X	X	X	X		X	X		X		X	
Holiday Inn		X	X	X	X	X	X			X		X		
Jackson Hewitt Tax Service	X	X	X	X	X	X		X	X		X	X		
Jazzercise	X	X	X	X	X	X		X	X	X	X	X	X	
McDonald's	X	X	X	X	X	X	X			X		X		X
Pizza Hut	X	X	X	X	X	X	X			X	X	X		
Subway	X	X	X	X	X	X		X			X	X		
Taco Bell	X	X	X	X	X	X	X				X	X	X	

Source: Franchise Disclosure Documents, 2014

The contract analysis buttresses the findings of a 2002 study of 10 randomly selected franchise agreements, which found "a substantial degree of uniformity" among the contracts. The author of that study concluded: "Most agreements include the same or similar versions of nearly all of the forty-seven provisions under review. Franchisor obligations are few and sharply circumscribed. . . . In contrast to the limited, carefully qualified obligations of the franchisor, franchisee obligations are many and often unqualified. . . . Moreover, many provisions under review are designed to deprive franchisees of legal rights and remedies that they would otherwise have."[30] As discussed in detail in the next section, these one-sided contracts effectively sanction several predatory and abusive practices by franchisors.

III. Franchisors engage in abusive, deceptive, or misleading practices in their contractual relationships with franchisees.

Enabled by their one-sided contracts, franchisors have engaged in unfair and predatory practices towards their franchisees. This section analyzes the prevalence of certain contract provisions tilted toward franchisors and details harmful practices – incomplete or misleading financial performance representations, unreasonable capital expenditure requirements, retaliation against members of franchisee organizations, arbitrary or pretextual terminations, arbitrary or pretextual nonrenewals, and onerous or arbitrary restrictions on transfer rights – and how they enrich the franchisor companies at the expense of small business owners. As the evidence collected by the petitioner shows, franchisees report these abusive practices occur with alarming frequency and in many sectors of the franchise industry.

A. Misleading Financial Performance Information

The Franchise Rule does not require franchisors to provide information to potential franchisees concerning the financial performance of franchised or company-owned outlets. If the franchisor chooses not to provide such information, termed financial performance representations" ("FPRs"), it must state in Item 19 of the FDD that it makes no "representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets" and does "not authorize our employees or representatives to make

[30] Peter Lagarias, *Franchising in California: Uniformity in California Franchise Agreements*, 21 FRANCHISE L.J. 136, 139 (Winter 2002).

any such representations either orally or in writing."[31] If the franchisor chooses to make a financial performance representation, the representation must be included in Item 19 of the FDD, and the franchisor must disclose whether the representation is "an historic financial performance representation about the franchise system's existing outlets, or a sublet of those outlets, or is a forecast of the prospective franchisee's future financial performance."[32] The franchisor must also have a "reasonable basis" for the representation and "written substantiation for the representation at the time the representation is made . . ."[33]

Despite collecting financial performance data from franchisees, most of the 14 leading franchise systems reviewed by petitioner provide inadequate financial performance information to prospective franchisees – or none at all:[34]

- Three franchisors provide no financial performance data at all,[35] and an additional seven franchisors provide no information on franchisee expenses, even though many disclose sales data for franchised stores or expense data for company stores only.[36] Thus, 10 of the 14 provide no direct gauge of franchisee profitability.
- For the remaining four systems that provide some franchisee expense data[37] the disclosure varies in quality. McDonald's, for example, provides no data on two major expenses: rent (which McDonald's controls as the landlord for virtually all franchised stores) and royalties (also clearly under McDonald's control), even though typical franchisees pay McDonald's 14.5 percent of their revenues in royalties and rent.[38] By failing to disclose these franchisee costs, McDonald's makes it impossible for prospective franchisees to determine the average franchisee's actual profit and to assess the potential performance of their investment.

[31] 14 C.F.R. § 436.5(s) (2).
[32] 14 C.F.R. § 436.5(s)(3)(i).
[33] 14 C.F.R. § 436.5(s)(3).
[34] The financial performance representations for each of the 14 franchise systems were taken from Item 19 of the respective systems' 2014 FDDs.
[35] The three are Subway, Jackson Hewitt and Jazzercise.
[36] The seven are Ameriprise, Applebee's, Burger King, Comfort Inn, Holiday Inn, Pizza Hut and Taco Bell. Of these seven, two systems, Pizza Hut, the country's largest pizza chain and Taco Bell, the biggest Mexican-style restaurant chain in the US – provide sales and expense data for company owned stores only, with no financial information at all on franchised stores. The remaining five systems provide sales data for franchised units but no expense information for franchised units.
[37] The four are 7-Eleven, Dunkin' Donuts, McDonald's and Great Clips.
[38] Mark Kalinowski, MCD: A "Typical" U.S. Franchised Restaurant's Annual Income Statement, Janney Capital Markets, Feb. 8, 2012 (on file with petitioner).

Despite refusing to disclose financial performance data to potential franchisees, franchisors often provide other parties, such as lenders requiring unit financial data to approve franchisees' loans, with detailed franchisee financial performance information. As the author of a law review article put it, "[o]ne of the ironies regarding FPRs is that even those franchisors that do not make FPR claims in their FDD must often create and distribute those exact same numbers to the financial institutions of prospective franchisees seeking financing to purchase the franchise."[39]

Some franchisors provide franchisee lenders with a "Bank Credit Report," which is compiled by franchise industry clearinghouse FranDATA and includes unit operating expenses, unit operating profit, owner compensation and break-even points among other performance metrics.[40] According to one franchisor, it is "easy to gather the data" for the report because "we currently also measure a lot of our franchise units with the metrics in-house. So we had all of this data available for them."[41] The report contains far more information on the profitability of a franchise system's units than is typically included in Item 19 of the FDD. According to FranDATA CEO Darrell Johnson, the report "puts weeks of franchise due diligence in the hands of banks who are not constrained by either the FTC or by FDD limitations, and this analysis of a brand's performance history gives a better prediction of their future performance."[42] Unfortunately, prospective franchisees do not have access to this information. "The report is never shown to franchisees or prospective franchisees. Lenders who access the report are asked to sign a Non-Disclosure Agreement, which prohibits them from showing the report to would-be borrowers."[43]

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[39] Marvin E. Rooks, *It is Time for the Federal Trade Commission to Require Financial Performance Representations to Prospective Franchisees,* 11 WAKE FOREST J. BUS. & INTELL. PROP. L. 55, 68 (2010).
[40] FranDATA. com, Franchise Financing PowerPoint presentation, slide 20, http://www.frandata.com/products/samples/Franchise_PPT_EdithWiseman_FRANdata.pdf (last visited May 7, 2015).
[41] Boefly.com, Exploring the Bank Credit Report (Webinar transcript), Mar. 5, 2012, http://www.boefly.com/blog/small-business-lending/exploring-the-bank-credit-report (last visited May 7, 2015).
[42] *Id.*
[43] Int'l Franchise Assoc., Understanding and Utilizing the SBA Financing Process, at 39, presented at Int'l Franchise Assoc. Legal Symposium, May 5-7, 2013, http://emarket.franchise.org/2013ls/Understanding%20and%20Utilizing%20the%20SBA%20Financing%20Process.PDF (last visited May 7, 2015).

Exhibit D

Although the Franchise Rule prohibits making financial performance representations outside Item 19 of the FDD, a web search turned up numerous advertisements making financial claims. Examples include:

- An ad for carpet cleaning franchise Chem Dry has the heading "Make more Money." The ad highlights an average annual revenue figure of $263,779 and states, "The revenue means you can quickly recoup your initial investment of $40,000 to $139,500 (depending on the number of territories and equipment packages you purchase)."[44] While Chem Dry's FDD does, in fact, include the $263,779 revenue figure,[45] it explicitly states "this financial performance representation does not reflect other variable or fixed operating expenses, or other costs or expenses that must be deducted from the revenue figures to obtain your net income or profit."[46] In other words, there is no backing in the FDD for the ad's claim that franchisees can "quickly recoup" their investment.

- An ad for moving franchisor Two Men and a Truck states: "New locations are also growing faster than ever, with recently launched locations hitting one **million dollars** of revenue in their first year," and "New franchisees can join the largest local mover in the U.S. and generate on average approximately $450,000 their first year in annual sales. This revenue increases to approximately $900,000 by their fourth year. Plus, the average net profit per franchise unit is 12%."[47] (emphasis in original). Item 19 of the FDD, however, makes no mention of "recently launched locations hitting one million dollars of revenue." Furthermore, while Item 19 reports average first-year sales of $455,797, in line with the ad, it reports average first-year expenses of $418,905, for a net profit of $36,892, or a margin of just over 8 percent,[48] well below the advertised 12 percent margin.

- Driveway maintenance franchisor Jet Black simply claims: "Profits, from day 1."[49] The franchisor's Item 19 disclosure, however, reveals nothing about profits. It includes only gross

[44]FranchiseDirect.com, Chem-Dry Carpet Cleaning web advertisement, http://www.franchisedirect.com/cleaningfranchises/chem-dry-carpet-cleaning-franchise-07022/ (last visited May 7, 2015).
[45] Chem_Dry FDD (2014), Item 19, at 30.
[46]*Id.* at 32.
[47] FranchiseGator.com, Two Men and a Truck web advertisement, http://www.franchisegator.com/two-men-and-a-truck-franchise/ (last visited May 7, 2015).
[48] Two Men and a Truck FDD (2014), Item 19, at 53.
[49]FranchiseGator.com, Jet Black web advertisement, http://www.franchisegator.com/jet-black-franchise/ (last visited May 7, 2015).

revenues and states, "The figures in the charts above do not reflect the cost of sales, operating expenses, or other costs or expenses that must be deducted from the Gross Revenues to obtain your gross profit, or net income or profit."[50]

In addition to advertising, 68 percent of franchisees in the March 2015 survey reported that before they joined their system a franchisor representative had made financial projections that were not included in the FDD, another clear violation of the Franchise Rule.[51]

An analysis of Small Business Administration data on loans to franchisees indicates that franchisees are put at serious risk by inadequate and misleading financial disclosure. The analysis of 64,191 loans to franchisees made from 1991 to 2010 through the SBA's largest lending vehicle, the 7(a) loan program, found:

- More than one out of every six SBA loans to franchisees made in the 20-year period, or 16.9 percent, had failed,[52] as of October 2014.[53]
- The failure rate has increased over time, from 12.7 percent in the first five-year period analyzed, 1991 to 1995, to 19.3 percent, nearly one failure for every five loans, in the most recent period, 2006 to 2010.[54] This represents a 52 percent increase in the failure rate over the period. Note that to exclude "unseasoned" loans – those made too recently to have failed – the report follows the methodology of the SBA Inspector General and excludes loans that originated after 2010.[55]
- The number of franchise systems with high failure rates – defined as over 20 percent – almost tripled over the 20-year period. For loans with origination dates in the 1991 to 1995 period, only 13.6 percent of systems had failure rates in excess of 20 percent, nearly one in seven systems. For loans originating in the 2006 to 2010 period, 35.9 percent of systems, or more than one in three, exceeded this benchmark.[56]

[50] Jet-Black Int'l FDD (2014), Item 19, at 36.
[51] Appendix 3, *supra* note 5 at 14.
[52] Service Employees International Union, *Risky Business: Franchisees' High and Rising Risk of SBA Loan Failure,* at 3, enclosed as Appendix 2. The report defines the failure rate as the share of loans charged off the SBA's books as a share of all loans made.
[53] *Id.* at 3.
[54] *Id.* at 4.
[55] *Id.* at 1.
[56] *Id.* at 5.

The results of this analysis—significant and worsening franchisee loan failure rates—reveal that franchisees are increasingly facing obstacles to success and that prospective franchisees could avoid bad investments through complete and accurate financial disclosures.

A published study comparing SBA loan data with FDD disclosures found that franchisees whose franchisors did not provide financial performance representations in Item 19 of their FDD were more likely to default on SBA loans than those whose franchisors included financial data in Item 19. Only 23 percent of franchise programs with an SBA franchisee default rate over 35 percent had made financial performance representations in Item 19. By contrast, of franchise programs with a 10 percent or lower franchisee default rate, 67 percent had made Item 19 FPRs.[57] Thus, the poorest-performing franchisors are less likely to provide financial performance data and, by extension, prospective franchisees are more likely to make unwise investment decisions.

In addition to studies cited above, numerous anecdotes demonstrate the disastrous consequences of inadequate financial performance disclosure and misleading advertising:

- Quiznos, a sandwich chain that spent part of 2014 in bankruptcy following several years of poor performance starting in the early 2000s, disclosed sales data in its FDD, but not expenses or profitability figures, and thus masked that most of its franchisees were struggling. In 2003, Quiznos was adding units faster than any other sandwich chain and had gone from #33 to #20 on the Nation's Restaurant News list of the top 100 restaurant chains by unit count in only two years.[58] Nonetheless, about 40 percent of Quiznos stores were not breaking even, according to a memo by a Quiznos attorney,[59] despite average gross sales per store that were near an all-time high. At the same time, Quiznos aggressively recruited new franchisees through Internet advertising, direct mail, radio, television, and in-store marketing.[60] Several franchisees alleged in lawsuits that Quiznos sales representatives made

[57] Marvin E. Rooks, *It is Time for the Federal Trade Commission to Require Financial Performance Representations to Prospective Franchisees*, 11 WAKE FOREST J. BUS. & INTELL. PROP. L. 55, 69 (2010).
[58] Alan J. Liddle, *Cash-Cow Chains Raise Growth Rate Amid Stress of Inflation*, NATION'S RESTAURANT NEWS, June 28, 2004; *Top 100 Chains Ranked by Latest-Year Total Number of U.S. Units*, NATION'S RESTAURANT NEWS, June 30, 2003; *Top 100 Chains Ranked by Latest-Year Total Number U.S. Units*, NATION'S RESTAURANT NEWS, June 28, 2004.
[59] Julie Creswell, *When Disillusion Sets In; Some Quiznos Franchisees Take Chain to Court*, NEW YORK TIMES, Feb. 24, 2007; *see also* Complaint ¶ 315, Avengers, Inc. v. QFA Royalties, No. 1:13-cv-00248 (MSK) (D. Colo. Jan. 31, 2013).
[60] Complaint ¶¶ 296-307, Avengers, Inc. v. QFA Royalties, No. 1:13-cv-00248 (MSK) (D. Colo. Jan. 31, 2013).

unsubstantiated claims about outlet costs and profitability, claiming, for example, that franchisees could earn margins ranging from 10 to 25 percent.[61]

- Cold Stone Creamery, an ice cream parlor chain, similarly hid financial distress from prospective franchisees through inadequate financial disclosures. In 2008, a Cold Stone franchisee sued the franchisor after filing for bankruptcy, claiming that Cold Stone had made exaggerated claims of profitability both in the Uniform Franchise Offering Circular and through a Cold Stone representative. The representative touted profit figures representing a margin of 19 to 24 percent, and the UFOC made revenue and profit claims based on data that excluded failed and terminated stores.[62] The franchisee settled the case. Around the same time, another Cold Stone franchisee sued, claiming that Cold Stone had promised a 25 to 30 percent profit margin despite the fact that Cold Stone had one of the highest SBA loan failure rates among all franchise systems.[63] Financial problems for Cold Stone franchisees persist; the failure rate for SBA-guaranteed loans to Cold Stone franchisees is almost 40 percent in the most recent five year period, according to the petitioner's analysis of SBA loan failure data**.**

- Shipping giant UPS bought Mail Boxes, Etc. ("MBE") in 2001, acquiring an instant retail presence at MBE's 4,300 stores across the country.[64] UPS decided to change the chain's model from offering several shipping services to a rebranded UPS Store offering only UPS. In a class-action lawsuit filed in 2003, the franchisees argued that, in order to persuade MBE franchisees to convert to the UPS Store model, UPS representatives promoted a study that purported to show that stores that fully converted to UPS Stores outperformed MBE and jointly-branded stores in revenue and net profit.[65] The franchisees claimed that of 3,500 stores in the MBE network, only 223 were selected to participate in the tests. Of that number,

[61] Second Amended Class Action Complaint ¶¶ 202-213, Siemer v. Quiznos Franchise Co., No.:1:07-cv-02170 (N.D. Ill. Sept. 18, 2009); *see also* Second Amended Complaint ¶ 93, Ballwin v. Quiznos Franchising LLC, No. 10-CV-3711 (Colo. Dist. Ct. Aug. 10, 2011); Complaint ¶ 328, Avengers, Inc. v. QFA Royalties, No. 1:13-cv-00248 (MSK) (D. Colo. Jan. 31, 2013).
[62] Second Amended Complaint ¶¶ 14, 30, Buraye v. Cold Stone Creamery, Inc., No: PC 043 905 (Cal. Sup. Ct. July 1, 2009).
[63] Second Amended Complaint ¶¶ 76-77, Tzamarot v. Cold Stone Creamery, Inc., No.: 09-24277 (RDD) (S.D.N.Y. Aug. 1, 2013).
[64] Amy Doan, *UPS Picks Up Mail Boxes Etc.*, FORBES, March 5, 2001, *available at* http://www.forbes.com/2001/03/05/0305ups.html.
[65] D.T. Woodard, Inc., v. Mail Boxes Etc., B228990, 2012 WL 90084, at *4 (Cal. Ct. App. Jan. 12, 2012) (reversing the trial court's summary judgment in favor of the franchisor).

only 25 percent of the stores submitted *any* type of profit data, and net profits, one of the key elements of the study, were actually not evaluated at all.[66] Nonetheless, UPS promoted the study to MBE franchisees, and 87 percent of them converted to the UPS Store.[67] By converting, the franchisees allege, they lost customers who preferred non-UPS services that MBE had formerly offered and made less per package on UPS shipments because UPS began setting maximum shipping prices.[68]

The evidence detailed above reveals that franchisors are violating the Franchise Rule by making FPRs outside of Item 19. Meaningful financial disclosure in Item 19 would assist prospective franchisees in gauging the financial risks of investing in a franchise and in assessing the accuracy of financial claims made in advertisements or through marketers.

B. Unreasonable Capital Expenditures

Franchisors often require franchisees to fund expensive renovations or equipment during the franchise agreement or as a condition of renewal. The Franchise Rule does not require disclosure of such outlays to prospective franchisees in the FDD. Indeed, of the 14 franchise systems reviewed by the petitioner, all but one of them allow the franchisor to impose capital expenditures on franchisees during the term of the agreement. Only one of these 13 includes any limits on or estimates of the costs of these investments, and that system, Jackson Hewitt, recently doubled the limit.[69]

The March 2015 survey indicates that franchisors do in fact typically keep franchisees in the dark about potential capital investments. Seventy percent of the franchisees said that, prior their purchase of the franchise, the franchisor had not provided a clear estimate of how much they would be required to spend on equipment, remodeling or other capital investments.[70] Fifty-eight percent of franchisees had been required to make major investments in equipment,

[66] Appellant's Opening Brief at 12-13, D.T. Woodard, Inc., v. Mail Boxes Etc., B228990 (Cal. Ct. App. May 24, 2011).
[67] *Id.* at 7.
[68] *Id.* at 45.
[69] The only system with such limits or estimates is Jackson Hewitt, and it doubled the limit on renovation costs during the franchise term from $12,500 in the 2013 version of its franchise agreement to $25,000 in the 2014 version. *See* Jackson Hewitt Franchise Agreement ¶ 11.2 (2013); Jackson Hewitt Franchise Agreement ¶ 11.2 (2014).
[70] Appendix 3, *supra* note 5, at 14.

renovations, or other capital improvements. Of those, the largest share, 49 percent, did not believe that those required investments had improved their business results.[71]

The generally unlimited ability of franchisors to impose capital expenditure requirements can cost franchisees millions of dollars, as evidenced by recent developments in the fast food sector, where, for example, leading hamburger chains Wendy's, Burger King and McDonald's are all requiring major investments by franchisees:

- Wendy's is suing at least one major franchisee for allegedly flouting the company's requirement to "refurbish a minimum of 60% of their restaurants over the next six years, at a rate of 10% per year."[72] These renovations cost as much as $1.5 million to $1.9 million per store for a "scrape and rebuild," with a less-thorough remodeling option costing $450,000 to $650,000 per outlet.[73] For context, the average sales of a Wendy's restaurant are an estimated $1.4 million a year.[74] The lawsuit alleges that DavCo, a longtime franchisee with over 150 stores in Maryland, Virginia and Washington, D.C,[75] is violating the franchise agreement by refusing to install a point of sale computer platform and to renovate its restaurants on Wendy's time frame.[76] According to DavCo, in the four years since the introduction of Wendy's "Image Activation" remodeling program, there have been nine different design iterations because "the designs have consistently proven to be economically unfeasible."[77]
- Burger King announced its "20/20" design remodels in October 2009.[78] The average cost to "reimage" a restaurant is between $300,000 and $350,000,[79] which amounts to about one-quarter to one-half of a franchisee's estimated annual sales of $1.2 million.[80] The company fines franchisees thousands of dollars if they fail to complete renovations in the required time

[71] *Id.* at 17.
[72] Complaint ¶ 1, Wendy's Int'l v. DavCo Restaurants LLC, No. 14- CV-013382 (Ohio Ct., Franklin Co. Dec. 22, 2014).
[73] The *Wendy's Company Q1 2014 Earnings Conference Call*, FAIR DISCLOSURE WIRE, May 8, 2014.
[74] *2014 Top 100: Estimated Sales Per Unit*, NATION'S RESTAURANT NEWS, June 30, 2014.
[75] Complaint ¶ 22, Wendy's Int'l v. DavCo Restaurants LLC, No. 14- CV-013382 (Ohio Ct., Franklin Co. Dec. 22, 2014); *see also* Lorraine Mirabella, *Wendy's Sues Franchisee for Md., Va. and D.C.*, BALTIMORE SUN, Jan. 6, 2015.
[76] Complaint ¶¶ 13, 23, Wendy's Int'l v. DavCo Restaurants LLC, No. 14- CV-013382 (Ohio Ct., Franklin Co. Dec. 22, 2014).
[77] Jonathan Maze, *Wendy's Franchisee Files Counterclaim Over Remodels*, NATION'S RESTAURANT NEWS, Feb. 20, 2015, http://nrn.com/corporate-news/wendy-s-franchisee-files-counterclaim-over-remodels.
[78] Ashley M. Heher, *Burger King Revamp Aims for an 'Edgy, Futuristic' Restaurant Look*, USA TODAY, Oct. 7, 2009, http://usatoday30.usatoday.com/money/industries/food/2009-10-06-burger-king-revamp_N.htm.
[79] *Burger King Worldwide Inc. at Barclays Retail and Consumer Discretionary Conference*, FAIR DISCLOSURE WIRE, Apr. 30, 2014.
[80] *2014 Top 100: Estimated Sales Per Unit*, NATION'S RESTAURANT NEWS, June 30, 2014.

frame.[81] By December 2013, 30 percent of all U.S. locations had completed the 20/20 remodel.[82] The company aims to reach 40 percent by the end of 2015.[83]

- McDonald's has imposed a remodeling program with estimated costs of $400,000 to $700,000 per store[84] and a "McCafe" combined beverage platform, which has required both equipment purchases and physical alterations to restaurants.[85] In addition, McDonald's has announced the installation of new prep tables[86] and, most recently, plans to roll out a burger customization program in up to 2,000 U.S. stores in 2015[87] that will cost between $100,000 and $150,000 per store.[88] The average McDonald's posts sales of $2.5 million per year.[89]

McDonald's has faced criticism from its franchisees for its onerous renovation requirements. In *Darling v. McDonald's*, a California appeals court affirmed a jury finding that McDonald's management had forced Sandra Darling, the franchisee, to sell her stores by imposing onerous capital expenditure requirements on her, such as requiring $450,000 in unnecessary improvements to one restaurant, and that McDonald's did so in order to gain control of her profitable store and to retaliate against her for her criticism of McDonald's practices.[90] Other McDonald's franchisees have complained anonymously in the past year that McDonald's frequently imposes remodeling costs on franchisees that do not result in greater sales and that ultimately benefit McDonald's, the franchisees' landlord.[91]

[81] Burger King FDD (2014), at 34.
[82] Trefis Team, *Burger King Worldwide New Coverage: $29 Trefis Price Estimate*, FORBES, Apr. 16, 2014, *available at* http://www.forbes.com/sites/greatspeculations/2014/04/16/burger-king-worldwide-new-coverage-29-trefis-price-estimate/.
[83] Wagar Saif, *Will Things Keep Going Burger King's Way*, THE MOTLEY FOOL, May 5, 2014, http://www.fool.com/investing/general/2014/05/05/will-things-keep-going-burger-kings-way.aspx; Alicia Kelso, *Burger King's 'Fewer, More Impactful' Menu Launch Strategy Lifts Sales,* QSR WEB, Aug. 14, 2014, http://www.qsrweb.com/articles/burger-kings-fewer-more-impactful-menu-launch-strategy-lifts-sales/.
[84] Leah Goldman, *A Tour Inside McDonald's Big $550,000-Per-Store Renovations*, BUSINESS INSIDER, May 13, 2011, http://www.businessinsider.com/remodeled-mcdonalds-photos-2011-5; Melissa Harris, *The Man Behind McDonald's New Look,"* CHICAGO TRIBUNE, May 16, 2010.
[85] In an investor call, then-CEO Don Thompson noted that the combined beverage platform required tearing out walls and resetting plumbing. *McDonald's Corp. Investor Meeting Transcript*, FAIR DISCLOSURE WIRE, Dec. 10, 2014.
[86] *McDonald's Corp. Analyst Meeting (Afternoon Session) Transcript*, FAIR DISCLOSURE WIRE, Nov. 14, 2013.
[87] *McDonald's Corp. Earnings Call Transcript*, FAIR DISCLOSURE WIRE, Jan. 23, 2015.
[88] *McDonald's Corp. at UBS Global Consumer Conference*, FAIR DISCLOSURE WIRE, Mar. 5, 2015.
[89] *2014 Top 100: Estimated Sales Per Unit*, NATION'S RESTAURANT NEWS, June 30, 2014.
[90] Darling v. McDonald's Corp., No. B171904, 2006 WL 164986 (Cal. App. 2006).
[91] Mark Kalinowski, MCD: Franchisee Survey Leads to Street-Low June U.S. Comp Estimate, Janney Capital Markets, July 16, 2014, at 5-11 (on file with petitioner).

Expensive capital investment requirements, coupled with broad nonrenewal and termination rights, mean that franchisees feel pressure to expend significant sums on remodeling or equipment just so they can continue to operate their businesses.

C. Retaliation against Members of Franchisee Associations

Independent franchisee associations provide a forum for discussing franchise-related problems, raising them collectively with the franchisor and protecting franchisees from the harmful practices outlined in this complaint. Despite such benefits, only an estimated 7 percent of franchise systems actually have an independent franchisee association, according to a franchisee news website.[92] This low number is unsurprising given the prevalence of franchisor hostility towards associations and franchisor retaliation against franchisees they perceive as challenging their authority. The March 2015 poll of franchisees found that 46 percent of franchisees had experienced at least one of the following: Being told by their franchisor that there could be negative consequences to participating in a franchisee association; being told by the franchisor there could be negative consequences for speaking out about problems within the system; or experiencing increased inspections or evaluations of their business after raising questions or speaking out about problems in the system.[93]

Several franchisees have alleged that they were terminated or not renewed in retaliation for their criticism of the franchisor's practices or their connection with a franchisee association.

- A former 7-Eleven executive attested in several lawsuits that the franchisor terminated "pain in the ass" franchisees and franchisee association leaders, many of whom were critical of the company's practices.[94]
- In 2006, Quiznos terminated eight franchisees active in an independent Quiznos franchisee association after the group posted on its website the suicide letter of a former California Quiznos franchisee who had killed himself after 18 months of litigation with Quiznos.[95]

[92] Don Sniegowski, *Top Winners All Have Independent Franchisee Associations*, BLUE MAU MAU, Jan. 28, 2011, http://www.bluemaumau.org/node/9912/talk#comment-108585.
[93] Appendix 3, *supra* note 5, at 22.
[94] Letter from Gerald A. Marks re Scheduling Order Exhibit 2, ¶¶ 45-47, 7-Eleven, Inc. v. Sodhi, No. 3:13-cv-03715-MAS-JS (D.N.J. May 6, 2014).
[95] Complaint at ¶¶32-33, Bray v. QFA Royalties, No: 1:06-cv-02528-JLK (D. Colo. Dec. 15, 2006).

Quiznos had terminated the California franchisee a month after he formed his own franchisee association.[96]

- McDonald's franchisees have stated that the chain refused to renew their franchises in retaliation for organizing with other franchisees[97] or criticizing the company.[98]

Fear of franchisor reprisal limits the ability of franchisees to build a counterweight to franchisors' power. As one 7-Eleven franchisee leader contends, "If we speak up, we risk retaliation. Right now, there are long-time 7-Eleven franchise owners—some owning stores for more than 40 years—being pushed out of their businesses."[99] A Maine Dunkin' Donuts franchisee concurred in testimony supporting a bill that would have protected franchisee free association rights: "[M]y father is currently the 2nd oldest Dunkin' Donut Franchisee in the system. He is very unsure about me coming here today. He is very concerned that if this bill does not pass we are all in jeopardy, and could face reprisals from our franchisor for speaking out. . . . We find it very disturbing at how easily our business can be taken away from us after more than 35 years of hard work and loyalty."[100]

D. Unfair Terminations

The terms of most franchise agreements allow unilateral terminations by the franchisor, and the effects of termination can be devastating for franchisees. According to the March 2015 survey, 76 percent of franchisees polled pledged their home, retirement savings or other personal assets as collateral for the loans they took out to buy their franchise.[101] Upon termination, franchisees may be able to sell certain tangible assets of the franchise back to the franchisor, but typically, franchisees lose the bulk of the value of their investment and may default on debt taken on to finance the business.

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[96] Timothy Noah, *Disenfranchised: Why Are Americans Still Buying Into the Franchise Dream*?, PACIFIC STANDARD, Mar. 4, 2014, *available at* http://www.psmag.com/navigation/business-economics/disenfranchised-fast-food-workers-quiznos-73967/.
[97] Kathryn Carter, *Leveling the Playing Field With the Likes of McDonald's*, THE LEFT HOOK, July 11, 2014. http://thelefthook.com/2014/07/11/leveling-the-playing-field-with-the-likes-of-mcdonalds/.
[98] First Amended Complaint ¶¶14, 28, Garrett v. McDonald's Corp., No. 4:05-cv-4 (FRZ) (D. Ariz. May 10, 2006).
[99] Jaspreet Dhillon, *Changes Urged in the Franchise System*, CAPITOL WEEKLY, July 17, 2014, http://capitolweekly.net/franchise-owners-rights-sb610/.
[100] Normand Boulay, Jr., Testimony before the Labor, Commerce, Research and Economic Development Committee of the Maine State Legislature, May 8, 2013 (on file with petitioner).
[101] Appendix 3, *supra* note 5, at 16.

All 14 franchise agreements in the petitioner's contract analysis contain a group of provisions that taken together allow the franchisor to terminate franchisees virtually at will. Specifically, all 14 contracts contain a catchall provision that essentially allows the franchisor to terminate the franchisee for any violation of the franchise agreement,[102] as well as a provision requiring compliance with operating manuals, policies and procedures that franchisees may have not seen prior to investing and that franchisors may modify, update or change unilaterally during the term of the agreement.[103] These rights, combined with the unrestricted right to inspect franchisee premises – usually unannounced[104] – effectively allow all 14 franchisors to terminate franchisees at will.

In addition to this set of "termination at will" provisions, franchisors in the set of 14 commonly enumerate other causes of termination that are broad. For example, all the systems except Burger King include language barring disparagement of the franchisor or franchisee conduct that reflects badly on the franchisor and the franchisor's brand.[105] Jackson Hewitt, for example, can terminate franchisees who "commit any act within or without the Franchised Business that would tend, in our judgment to reflect poorly on the goodwill of our name or any

[102] *See* Appendix 1, Part A. Although most of the agreements require notice before termination, some of the agreements require only one breach and failure to cure before the franchisor can terminate. For example, Dunkin' Donuts franchise agreement simply states "if you fail to timely cure any default that may be cured, we may terminate this Agreement." Dunkin' Donuts Franchise Agreement ¶14.6 (2014). Similarly, Fitness franchisor Jazzercise specifies that it may terminate franchisees if they fail to cure "noncompliance with any requirement in this Agreement not listed in Subsection B above within thirty (30) days after notice thereof is delivered to Franchisee." Jazzercise Class Owner Franchise Agreement ¶13.C (1) (2014). Taco Bell's franchise agreement allows it to terminate "at any time" not only the franchise for the location that it finds in default but "any other such franchise agreement" in cases of default that continue for 30 days after written notice from the franchisor. Taco Bell Franchise Agreement ¶15.0 (2014).

[103] McDonald's, for example, requires franchisees "to promptly adopt and use exclusively the formulas, methods, and policies contained in the business manuals, now and as they may be modified from time to time" and specifies that, "[s]uch manuals, as modified from time to time, and the policies contained therein, are incorporated in this Franchise by reference." McDonald's Franchise Agreement ¶4 (2014).

[104] Nine of the 14 systems explicitly state that inspections may be unannounced/without notice – Ameriprise, Applebee's, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt, Jazzercise, Taco Bell and Subway**.** *See* Appendix 1, Part A, Section 4. For example, Burger King "shall have the unrestricted right to enter the Franchised Restaurant to conduct such activities as it deems necessary to ascertain Franchisee's compliance with this Agreement. The inspections may be conducted without prior notice at any time when Franchisee or one of his employees is at the Franchised Restaurant." Burger King Individual Owner/Operator Franchise Agreement ¶5(J) (2014). Four of the remaining five systems – Holiday Inn, McDonald's, Comfort Inn and Pizza Hut – require franchisees to give access to their premises at any time or any reasonable time but do not explicitly specify that the access may be without notice. One system, 7-Eleven, states that inspections will be on 72 hours notice. *See* Appendix 1, Part A, Section 4.

[105] *See* Appendix 1 Part A, Section 5.

of our Marks, Operating System, or the Network, and you fail to cease this activity or cure this breach within five (5) days after delivery of notice."[106]

The International Franchise Association enshrines as a guiding principle that franchisees "should have the opportunity to monetize any equity they may have developed in their business prior to the expiration or termination of the franchise agreement."[107] Nonetheless, franchisees can seldom count on realizing much value from their business if their franchise is terminated. For example, the McDonald's and Burger King franchise agreements give the franchisor the option to purchase various assets, but neither agreement *requires* the franchisor to purchase assets, and the McDonald's agreement specifically states that "there shall be no payment by McDonald's for intangible assets of Franchisee,"[108] for example, goodwill built up over years of serving customers. The Choice Hotels franchise agreement lists four sets of obligations for the terminated franchisee upon termination, and no obligation of the franchisor toward the franchisee.[109] Because the consequences of termination are so dire, the threat of termination is the stick franchisors use to impose onerous operating and expenditure requirements on franchisees and eliminate criticism of the franchisor's practices.

The March 2015 survey of franchisees found that franchisors often use termination threats:

- 80 percent of franchisees reported that their franchisor told them they could face termination or nonrenewal based on violations identified during inspections, which, as noted above, can typically happen at any time without notice.[110]
- 38 percent of franchisees reported that their franchisor had told them they might be terminated because of actions they thought were appropriate for the operation of their business.[111]

Franchisees have alleged in litigation, legislative hearings and in the media that franchisors have used their virtually unfettered termination power to generate profit by reselling

[106] Jackson Hewitt Franchise Agreement ¶19.2(t) (2014).
[107] Int'l Franchise Assoc., *Statement of Guiding Principles*, http://www.franchise.org/statement-of-guiding-principles (last visited May 4, 2015).
[108] McDonald's Franchise Agreement ¶20 (b) (2014).
[109] Choice Hotel Int'l Franchise Agreement ¶11 (2014).
[110] Appendix 3, *supra* note 5, at 22.
[111] *Id.* at 23.

franchise units, to chill franchisee dissent and organizing efforts, and for other reasons wholly unrelated to their performance:

- 7-Eleven has terminated franchisees to "seize the stores of profitable franchisees without providing them fair compensation" and refranchise them at higher prices or to retaliate against franchisees critical of 7-Eleven's practices, according to an affidavit submitted by a former 7-Eleven loss prevention officer in several franchisee lawsuits.[112] The former loss-prevention officer attested that 7-Eleven targeted for termination stores run by "pain in the ass" franchisees and independent franchisee association leaders. [113] One couple charged that 7-Eleven representatives forced them to give up their store by threatening them with a lawsuit and interrogating them for hours about alleged coupon fraud without allowing them to see the evidence against them or present evidence that they had redeemed the coupons correctly.[114]
- Former Dunkin' Donuts franchisee Stanley Furash told Massachusetts legislators in 2011 that after he had improved the performance of his two stores, Dunkin' terminated him on a pretext in order to resell the stores.[115] Other critics support Furash's interpretation, asserting that after three private-equity firms bought Dunkin' Donuts in 2006, the debt-laden company pressured franchisees to pay penalties and sell their stores or face termination.[116]
- In 2006, Quiznos terminated eight franchisees active in an independent Quiznos franchisee association after the group posted on its website the suicide letter of a former California Quiznos franchisee who had killed himself after 18 months of litigation with Quiznos.[117]

[112] Letter from Gerald A. Marks re Scheduling Order at 10, 7-Eleven, Inc. v. Sodhi, No. 3:13-cv-03715-MAS-JS (D.N.J. May 6, 2014).
[113] *Id.* at 15-16.
[114] Tiffany Hsu, *Franchisees Allege Hardball Tactics, Store Seizures by 7-Eleven*, LOS ANGELES TIMES, June 4, 2014, *available at* http://www.latimes.com/business/la-fi-7-eleven-lawsuits-20140605-story.html#page=2; Amended Complaint at 7-12, Patel v. 7-Eleven, Inc., No. 5:14-cv-00519 (PSG) (C.D. Ca. June 3, 2014).
[115] Blue Mau Mau, Franchisees Paint Grim Scenes of Dunkin', July 13, 2011, http://www.bluemaumau.org/10538/franchisees_paint_grim_scene_dunkin. Furash reported that the franchisor's reason for termination was the fact that he lived in a different state from his stores, even though, he testified, the contract did not prohibit living in a different state and he actually worked in the stores.
[116] Holly Sanders Ware, *Flunkin' Donuts*, NEW YORK POST, Sept. 3, 2009, *available at* http://nypost.com/2009/09/03/flunkin-donuts/.
[117] Complaint at ¶¶32-33, Bray v. QFA Royalties, No: 1:06-cv-02528-JLK (D. Colo. Dec. 15, 2006).

Quiznos had terminated the California franchisee a month after he formed his own franchisee association.[118]

- In the early 2000s, franchisees of car rental franchise Rent-A-Wreck claimed that the company, which was struggling financially, used audits to drive franchisees out of business and enable the company to resell the franchises.[119]
- In the 2010 *Trocki v. Choice Hotels* case, the franchisees contended that the franchisor's termination notices came after the franchisee had used the franchisor's official internal process to object to an application to rebrand the hotel next door as a Choice hotel.[120] The franchisees claimed that after Choice forced them out, they had to reflag their hotel with a less prominent brand, which drew fewer customers, and their formerly profitable hotel began operating at a loss.[121]
- In a complaint to the FTC dated July 7, 2014 ("McDonald's FTC Complaint"), franchisees of 27 McDonald's restaurants in Puerto Rico alleged that McDonald's violated the Franchise Rule by unilaterally imposing a sub-franchisor for all franchisees in Puerto Rico. According to the complaint, the sub-franchisor instituted an advertising campaign and barred sub-franchisees who did not contribute financially to the campaign from selling products promoted in the campaign. After certain sub-franchisees voluntarily honored customers' requests for products advertised through the campaign, those sub-franchisees were threatened with termination for selling unauthorized products.[122]

The options for franchisees facing termination are bleak: costly litigation or arbitration; selling the franchise to a franchisor-approved buyer (often at fire sale prices); or the loss of their financial investment and years of sweat equity.

E. Unfair Nonrenewals

[118] Timothy Noah, *Disenfranchised: Why Are Americans Still Buying Into the Franchise Dream*?, PACIFIC STANDARD, Mar. 4, 2014, *available at* http://www.psmag.com/navigation/business-economics/disenfranchised-fast-food-workers-quiznos-73967/.
[119] Robyn Lamb, *Rent-A-Wreck, Family Owners Struggle Through Legal Disputes*, THE DAILY RECORD (Baltimore), Sept 3, 2004.
[120] Notice of Removal Exhibit 1 ¶¶13-2, Trocki Hotels v. Choice Hotels Int'l, No. 1:10-cv-5177 (RMB) (D.N.J. Oct. 7, 2010).
[121] *Id.* ¶ 27.
[122] Complaint by 78% of Puerto Rico Franchisees Against McDonald's Corporation and Others in Concert Therewith Pursuant to FTC Act Section 5 and the Franchise Rule, July 4, 2014, at 15 (on file with requesters).

Franchise agreements often grant franchisors complete discretion in deciding whether to renew a franchise. A franchise nonrenewal is not merely the end of a contract; it is the loss of a franchisee's decades-long business, livelihood, and sweat equity. And, unlike a normal contract, franchisees typically cannot find another party to contract with. The tangible assets and know-how they have acquired cannot be used to contract with a different franchisor because of the prevalence of noncompetition clauses. Of the 14 franchise agreements reviewed, 11 include some restrictions on the ability of terminated or nonrenewed franchisees to compete with their former franchisors. Nine bar former franchisees from competing in the same line of business or in the same physical location as their former unit for some period of time, ranging from one to three years, after the franchise agreement expires or is terminated.[123] Two have other restrictions on competitive activity for former franchisees.[124] Even in the lodging industry, where franchisees typically own a hotel that they may rebrand if their franchisor does not renew, such moves often result in losses for the franchisee, as in the *Trocki* case discussed above and in the case of California hotelier Vipul Dayal, who stated,

> InterContinental Hotels Group revoked one of my families' franchises—even though this property had been a Holiday Inn Express for years and met all of the corporation's standards. We had no say in this decision, but felt the impact of it. It took years to rebuild the client base for this hotel, and in the first year after the change, its occupancy rate was cut nearly in half.[125]

In sum, franchisees often can only realize a reasonable value for their investment by contracting and renewing with the franchisor, which makes nonrenewals unrelated to performance particularly unfair and financially devastating for franchisees.

All of the 14 franchise agreements in the petitioner's contract analysis provide no renewal rights or significantly limit franchisees' renewal rights. Five of the 14 systems – McDonald's, Pizza Hut, Taco Bell, Holiday Inn and Comfort Inn – specify that franchisees have no renewal rights at all.[126] All of the remaining nine systems indicate that any renewal may be on

[123] The nine are 7-Eleven, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service, Jazzercise, McDonald's, Pizza Hut and Subway. *See* Appendix 1, Part C, Section 1.
[124] The two are Ameriprise, which bars former franchisees from seeking to serve their former Ameriprise clients for one year after termination of the agreement, and Taco Bell, which imposes competition restrictions on former franchisees terminated for cause for one year after termination of the agreement. *See* Appendix 1, Part C, Section 2.
[125] Service Employees International Union, Restore Fairness for California Franchise Owners, 2014 (on file with petitioner).
[126] The five are Comfort Inn, Holiday Inn, McDonald's, Pizza Hut and Taco Bell. *See* Appendix 1, Part B, Section 1.

materially different terms than the franchisee's current contract.[127] This could mean higher royalties, a mandate for expensive renovations or equipment purchases or other unwelcome changes. Six of the nine systems that allow renewals require renewing franchisees to release the franchisor from any claims arising from the prior franchise agreement.[128] In other words, if franchisees want to stay in business, they have to give up the right to sue for any contract violations the franchisor may have committed during the previous term of the franchise contract.

As a Dunkin' Donuts franchisee wrote in a letter supporting a Maine franchisee rights bill:

> Presently Franchise Owners who adhere to brand standards and honor their obligations can only watch their equity evaporate as the end of their franchise term nears. Without reasonable assurances of renewal our family businesses essentially become rent-a-businesses and are worthless to anyone except the Franchisor. Franchise Owners are often presented with one of two options; Sign a more draconian new form franchise agreement or walk away from their life's work and family's business equity.[129]

Because franchise contracts typically have little or no protection of franchisees' renewal rights, franchisors may force franchisees to give up their businesses at the end of the franchise term for reasons unrelated to their performance. To cite some examples:

- A longtime McDonald's franchisee alleged publicly that the franchisor had not renewed the franchise on one of her stores in retaliation for her advocacy of franchisee rights legislation in California.[130] Similarly, in 2006, an Arizona couple who owned McDonald's restaurants in Tucson claimed in a lawsuit that McDonald's had a plan to remove franchisees who were either the most profitable or the most vocal in opposition to McDonald's management or policies. They alleged that they fell victim to this plan when McDonald's refused to renew their franchise after they became outspoken about the chain's unfair treatment of them.[131]
- In June 2010, one month after its franchisee filed an arbitration challenging the company's requirement to use its tax preparation software, H&R Block notified the franchisee of its

[127] The nine are: 7-Eleven, Ameriprise Financial Services, Applebee's Neighborhood Grill & Bar, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service, Jazzercise and Subway. *See* Appendix 1, Part B, Section 2.
[128] The six are 7-Eleven, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service and Jazzercise. *See* Appendix 1, Part B, Section 3.
[129] Maine Franchise Owners Assoc., Letter from Maine Franchise Owners Chairman Ed Wolak, Feb. 21, 2014. http://www.mainefranchiseowners.org/letter-from-maine-franchise-owners-chairman-ed-wolak/ (last visited May 5, 2015).
[130] Carter, *supra* note 97.
[131] First Amended Complaint ¶¶14, 28, Garrett v. McDonald's Corp., No. 4:05-cv-4 (FRZ) (D. Ariz. May 10, 2006).

intent not to renew two franchise agreements when they expired at the end of the year.[132] In 2012, a federal appeals court ruled that H&R Block had the right to deny the franchise renewals, despite the fact that the franchise agreements stated that they "shall automatically renew" for five-year terms, because this language did not indicate an unequivocal intention by the parties that the contract continue in perpetuity.[133]

The arbitrary and retaliatory nonrenewal of franchise agreements harms franchisees and chills critical speech and collective action by franchisees.

F. Interference with Transfer or Sale

Franchisees may want to transfer their franchise to a family member or to another qualified buyer during the term of the agreement, often so that they can retire and realize the value of decades of investment. Franchise agreements, however, typically grant franchisors broad discretion to approve or deny transfers, which mean the process is vulnerable to franchisor abuse. Franchisors often have the right to deny a transfer for any reason or can require a franchisee to sell to the franchisor's preferred buyer at a lower price. While it is reasonable for a franchisor to require approval of transfers to ensure that only individuals meeting its qualifications enter the business, it is unreasonable when franchisors adopt no clear standards for their transfer process or enforce standards in an arbitrary way, thereby allowing them to behave opportunistically, often to the franchisee's detriment. A franchisee of nine Burger King restaurants in Maine explained to legislators the importance of transfer rights: "As part of a family business it has always been a dream of mine to start a business that can be passed down from generation to generation." Protecting transfer rights "goes a long way to making that dream a reality by ensuring that I remain in control of the transfer process and limiting the power the franchisor has to move this business as they see fit."[134]

Eight of the 14 franchise agreements reviewed allow the franchisor broad discretion to approve or reject franchisees' proposed sales or transfers of their units.[135] For example,

[132] H&R Block FDD (2012), at 16; Complaint ¶ 19, H&R Block Tax Services LLC v. Franklin, 4:10-cv-1165 (DW) (W.D. Mo. Nov. 23, 2010).
[133] H&R Block Tax Services LLC v. Franklin, 691 F.3d 941, 945 (8th Cir. 2012).
[134] Testimony of Larry & Brek Kohler in Support of LD 1458, an Act to Enact the Maine Small Business Investment Protection Act, May 8, 2013 (on file with petitioner).
[135] The eight are 7-Eleven, Ameriprise Financial Services, Applebee's, Burger King, Holiday Inn, Jazzercise, McDonald's and Pizza Hut. *See* Appendix 1, Part D, Section 1.

Applebee's states "nothing in this Appendix B shall limit Franchisor's discretion in granting or withholding consent to a Transfer or to require the applicable parties to agree to certain terms as a condition to obtaining consent to a Transfer."[136] In addition to this broad discretion, franchise agreements commonly include various restrictions on transfers, including a required general release of claims on the franchisor before approving a transfer (11 systems)[137] and a provision allowing the franchisor to block a sale based on contract violations by the transferring franchisee (10 systems).[138] Three systems allow the franchisor to require that the transferring franchisee refurbish their facility (Great Clips) or bring it up to current standards of appearance (Jazzercise and Taco Bell).[139] This can force franchisees who want to leave the system because they are in difficult financial straits to make a further, often costly, investment in a system they are trying to exit. Two systems, McDonald's and Burger King,[140] require franchisees who sell their stores to retain liability for the buyer's royalties for some period. McDonald's franchise agreement allows it to hold former franchisees liable for "all affirmative obligations, covenants, and agreements" for the full term of the selling franchisee's original agreement, even after the franchise has been transferred, with McDonald's approval, to a new owner.[141]

In addition to arbitrary denials of transfers, many franchisees report malicious interference by franchisors in their efforts to find a purchaser for a franchise:

- A former McDonald's franchisee alleged in a 2012 bankruptcy filing that McDonald's repeatedly interfered with offers to buy its stores with the intent that the franchisee sell the stores to McDonald's preferred buyer at a significantly reduced price.[142]
- In a lawsuit filed in 2011, AM/PM gas station/convenience store franchisees alleged that their franchisor, BP, had "a history of giving unreasonable and untimely approvals or denials when franchisees wish to sell their franchises" and of placing unreasonable restrictions on

[136] Applebee's Franchise Agreement, Appendix B (2014).
[137] The 11 are 7-Eleven, Ameriprise Financial Services, Applebee's, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service, Jazzercise, Pizza Hut, Subway and Taco Bell. *See* Appendix 1, Part D, Section 2.
[138] The 10 are 7-Eleven, Ameriprise Financial Services, Dunkin' Donuts, Holiday Inn, Jackson Hewitt Tax Service. Jazzercise, McDonald's, Pizza Hut, Subway and Taco Bell. *See* Appendix 1, Part D, Section 3.
[139] *See* Appendix 1, Part D, Section 4.
[140] *See* Appendix 1, Part D, Section 5.
[141] McDonald's Franchise Agreement, ¶15(d) (2014).
[142] Debtors' Omnibus Response to Objections of McDonald's and Lake Forest Bank ¶¶ 5-9, 18-25, 37, In re Azuka Foods, Inc., No. 11-40934 (ESS) (E.D.N.Y. Sept. 5, 2012).

lenders in ways that restricted franchisees' ability to sell their units and lowered the value of the franchises.[143]

- In 2006, a Cold Stone Creamery franchisee sued the ice cream franchisor, alleging that the company had blocked his attempts to sell his stores by telling potential buyers they could buy franchises directly from Cold Stone for less money.[144] The parties settled the case in 2008 after the franchisee filed for bankruptcy.[145]

- In a currently pending case, an Oregon-based franchisee of Jackson Hewitt alleges that the franchisor interfered in its efforts to get the best price for six Idaho tax preparation franchises it was selling in 2010. According to the lawsuit filed in May 2013, Jackson Hewitt imposed an unrealistic two-week time frame for finding prospective buyers for the Idaho franchises and then rejected a suitable buyer.[146]

- According to the McDonald's FTC Complaint, McDonald's franchisees in Puerto Rico have been forced to accept a new sub-franchisor "that unfairly competes with them, radically changes their franchise, and intentionally impacts sales in their restaurants." They "have been given only one alternative to resolve the current situation - jointly to sell all of their restaurants to the sub-franchisor at a discounted value."[147]

The breadth of franchisors' discretion to deny transfer or assignment of a franchise enables abusive and harmful practices by franchisors.

IV. Petition for Investigation

The FTC has authority to undertake investigations into specific wrongdoing as well as general industry practices pursuant to Sections 6, 9, 20, and 21 of the FTC Act. These provisions give the Commission a variety of methods of obtaining information, including the power to issue civil investigative demands. Section 6(b) grants the Commission the power:

> [t]o require, by general or special orders, persons, partnerships, and corporations, engaged in or whose business affects commerce . . . or any class of them, or any

[143] Class Action Complaint ¶ 59, Green Desert Oil Group Inc. v. BP West Coast Products LLC, 3:11-CV-2087 (CRB) (N.D. Ca. Apr. 28, 2011).
[144] Amended Complaint ¶ 65, Prasad v. Cold Stone Creamery, Inc., No. 3:06-cv-00648 (MLC) (D.N.J. Feb. 1, 2007).
[145] Cold Stone Creamery FDD (2014), at 27-28.
[146] Amended Complaint ¶¶ 101-18, FasTax Inc. v. Jackson Hewitt, Inc.., No: 2:13-cv-03078 (WJM) (D.N.J. July 15, 2014).
[147] Complaint by 78% of Puerto Rico Franchisees against McDonald's Corp., *supra* note 122, at 20.

> of them, respectively, to file with the Commission in such form as the Commission may prescribe annual or special, or both annual and special, reports or answers in writing to specific questions, furnishing to the Commission such information as it may require as to the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals of the respective persons, partnerships, and corporations filing such reports or answers in writing.[148]

Given the substantial evidence of pervasive abuses in the franchise industry, the FTC should compel the provision of information from no fewer than nine leading franchise companies concerning their relationships with and conduct towards their franchisees. In particular, the FTC should compel the provision of information concerning:

(1) each franchisee terminated in the last 10 years and the reasons for termination;

(3) the franchisor's policies on franchise termination;

(4) each franchisee who was not renewed in the last 10 years and the reasons for nonrenewal;

(5) the franchisor's policies on franchise renewal;

(6) each franchisee who requested the transfer or sale of one or more franchise units in the past 10 years and the handling and disposition of each proposed transfer or sale, including the date on which the transfer or sale was requested, the date on which the transfer or sale was approved or rejected by the franchisor, the reason for the approval or rejection, the price received by the transferring franchisee for each franchise unit sold, and the name and contact information for the recipient of the transfer;

(7) the franchisor's policies on transfer and sale of franchises;

(8) each capital expenditure program with an average cost per franchised unit of $10,000 or more required or initiated by the franchisor in the last 10 years and the mean and median cost to franchisees of each expenditure;

(9) the franchisor's policies on capital expenditures by franchisees;

(10) each financial performance representation made by franchise representatives, in advertisements or in other marketing materials in the last 10 years;

(11) the income and expenses of each franchised unit, organized by number of years in the franchise system;

[148] 15 U.S.C. § 46(b).

(12) all financial performance information provided to potential franchisee lenders, including the SBA, in the last 10 years;
(14) whether the franchisor participates in the FranDATA "Bank Credit Report" program;
(11) all documents, policies, procedures and manuals incorporated by reference into the franchise agreement;
(12) for each document identified in item 11, state the number of pages in the document and identify each change to the document made in the last 10 years;
(13) the number and date of each type of inspection or audit conducted on each franchise outlet in the last 10 years; and
(14) the contact information for all franchisees who exited the system in the last 10 years.

The evidence summarized in this petition shines a light on the power imbalance in the franchise relationship that results in serious financial harm to franchisees. Franchisees often enter into the relationship on the basis of inadequate or misleading financial performance information. Once they sign the agreement, they may be subject to the franchisor's changing operating requirements and unreasonable capital expenditure demands, and they can lose their investment and their financial security if they challenge rather than accede to these demands. For these reasons, the petitioner asks the FTC to order franchise companies selected for this investigation to provide the information listed above so that the FTC can investigate the existence and extent of the harmful practices described in this request and issue a report with the agency's finding and recommendations.

Exhibit D

Appendices:

1. Analysis of contract terms of 14 leading franchise systems
2. Risky Business: Franchisees' High and Rising Risk of SBA Loan Failure
3. FranchiseGrade.com, Inc., *National Survey of Franchisees 2015*

Exhibit D

ARE FRANCHISEES WELL-INFORMED? REVISITING THE DEBATE OVER FRANCHISE RELATIONSHIP LAWS

Robert W. Emerson & Uri Benoliel***

ABSTRACT

The most vital debate in the field of franchise contract law over the last few decades has focused on the following issue: Whether the law should protect franchisees against franchisor opportunism. Franchisor advocates suggest that franchisee protection laws, commonly known as "franchise relationship laws," are undesirable. Their opposition to such laws is based primarily on an assumption that franchisees consider all relevant information before signing a franchise contract and make a well-informed choice among the range of franchise alternatives available. In particular, prior to signing the contract, franchisees are assumed to have read the franchise disclosure documents made available to them, compare the various contracts and disclosure documents offered by different franchisors, and consult with a specialized franchise attorney regarding the terms of the franchise contract. Since franchisees consider all of the relevant information and make a well-informed decision, they do not deserve, according to franchisor advocates, any special legislative protection that would interfere with the franchisor-franchisee free-market relationship.

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Based on a significant body of existing empirical research, which has thus far been overlooked in the debate over franchise relationship laws, this article will argue that the assumption that franchisees consider all relevant information before signing a franchise contract and make a well-informed choice is questionable. Briefly summarized, the argument presented in this article is as follows: New franchisees that join a franchise network normally lack prior business ownership experience. This lack of experience presents significant cognitive obstacles for novice franchisees when attempting to consider all of the relevant information before acquiring ownership of a franchise unit. Such cognitive obstacles—contrary to the franchisor advocates' view—often lead franchisees to ignore franchise disclosure documents, avoid conducting a comparison between various franchise contracts and disclosure documents, and neglect to consult with a specialized franchise attorney prior to signing the franchise contract. Given this reality, theoreticians and legislators interested in creating franchise laws that protect novice franchisees from possible opportunism by franchisors must cast doubt on the assumption that franchisees are well-informed business people and incorporate into their analyses a more representative conception of franchisee characteristics.

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I. INTRODUCTION

The most vital debate in the field of franchise contract law over the last few decades has focused on the issue of whether the law

should protect franchisees against franchisor opportunism.[1] Franchisor advocates claim that franchisee protection laws, commonly known as "franchise relationship laws," are undesirable.[2] Their opposition to such laws is based mainly on an assumption that franchisees consider all relevant information before signing a franchise contract and make a well-informed choice among the range of franchise alternatives available.[3] In particular, according to this analysis, prior to signing the franchise contract, franchisees read the franchise disclosure documents made available to them before signing the franchise contract, compare the various contracts and disclosure documents offered by different franchisors, and consult with a specialized franchise attorney regarding the terms of the franchise contract.[4] According to franchisor advocates, since franchisees consider all of the relevant information and make well-informed decisions, they do not require any special legislative protection that would interfere with the franchisor-franchisee free market relationship.[5] Franchisor advocates' opposition to franchise relationship laws has been significantly influential in the development of franchise law in general, as is evident in state and federal policy making.[6] To date, most states have refused to adopt general franchise relationship laws.[7] At the federal level, such laws have been rejected entirely.[8]

Empirical evidence, however, casts significant doubt on the theoretical assumption that, before signing a franchise contract, franchisees consider all relevant information which leads to a well-informed choice.[9] Briefly summarized, the argument presented in this article is as follows: New franchisees that join a franchise network normally lack prior business ownership experience.[10] This lack of experience presents significant cognitive obstacles for novice franchisees when attempting to consider all of the relevant information before acquiring ownership of a franchise unit.[11] Specifically, inexperienced franchisees often do not know in which

1 *See infra* Part II.
2 *See infra* Part III.
3 *See infra* Part III.
4 *See infra* Part III.
5 *See infra* Part III.
6 *See infra* Part II.
7 *See infra* Part II.
8 *See infra* Part II.
9 *See infra* Part IV.B.2.
10 *See infra* Part IV.A.
11 *See infra* Part IV.B.1.

subjects they are ignorant or what information they should consider before acquiring ownership of a franchise unit (the "unawareness problem").[12] In addition, unseasoned franchisees must invest significant cognitive efforts in distinguishing between relevant and irrelevant business and legal information on franchise ownership ("screening difficulty").[13] Finally, novice franchisees have great difficulty in fully understanding the business and legal data to which they are exposed in the pre-contractual process, or how to place it in context, evaluate it, and act accordingly ("comprehension limitations").[14] Such cognitive obstacles often lead franchisees—contrary to the franchisor advocates' view—to ignore franchise disclosure documents, avoid conducting a comparison between various franchise contracts and disclosure documents, and neglect to consult with a specialized franchise attorney prior to signing the franchise contract.[15]

This article proceeds as follows: Part II will provide legal context by briefly reviewing the statutory framework underlying the debate over the desirability of franchise relationship laws. Part III will provide theoretical context through outlining the assumption on which franchisor advocates base their opposition to franchise relationship laws—namely, that franchisees consider all relevant information before signing a franchise contract and make a well-informed decision. Part IV will present our critique of the franchisor advocates' assumption.

II. FRANCHISE RELATIONSHIP LAWS—OVERVIEW

Franchise relationship laws are statutes that mainly govern the ongoing relationship between franchisors and franchisees.[16] These laws have two central alleged purposes: first, to correct a perceived inequality in bargaining power between franchisors and franchisees;[17] and second, to protect franchisees against perceived

[12] *See infra* Part IV.B.1.
[13] *See infra* Part IV.B.1.
[14] *See infra* Part IV.B.1.
[15] *See infra* Part IV.B.2.
[16] *See* David Hess, *The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors*, 80 IOWA L. REV. 333, 346–47 (1995). *See generally* Thomas M. Pitegoff & W. Michael Garner, *Franchise Relationship Laws*, *in* FUNDAMENTALS OF FRANCHISING 183, 184 (Rupert M. Barkoff & Andrew C. Selden, eds., 3d ed. 2008) (offering a general overview of the "franchise relationship" laws that govern following the signing of a franchise agreement).
[17] *See* NEB. REV. STAT. § 87-401 (2012); N.J. STAT. ANN. § 56:10-2 (West 2012); R.I. GEN. LAWS § 19-28.1-2 (2012); VA. CODE ANN. § 13.1-558 (2012); WIS. STAT. § 135.025(2)(b) (2012);

abusive behavior by franchisors.[18] The major franchisor abuses[19] at which franchise relationship laws are aimed include: unjust termination of the franchise contract without adequate notice or reasonable cause,[20] restrictions on free association among franchisees,[21] requirements of arbitration outside the franchisee's state,[22] and encroachment on the franchisee's territory—namely, establishment of a new franchise unit in unreasonable proximity to an existing franchisee.[23] Notably, such abuses often are prohibited by *mandatory* franchise relationship laws, regardless of the express franchise contract provisions.[24]

To date, only a minority of states have enacted general franchise relationship laws that are not restricted to particular industries.[25]

Christopher J. Curran, *Claims Against a Franchisor Upon an Unreasonable Withholding of Consent to Franchise Transfer*, 23 J. CORP. L. 135, 152 (1997); Peter C. Lagarias & Robert S. Boulter, *The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections*, 29 FRANCHISE L.J. 139, 141 (2010); Dennis D. Palmer, *Franchises: Statutory and Common Law Causes of Action in Missouri Revisited*, 62 UMKC L. REV. 471, 491 (1994); Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289, 289 (1989).

[18] *See* WIS. STAT. § 135.025(2)(b); Geib v. Amoco Oil Co., 29 F.3d 1050, 1056 (6th Cir. 1994); Bitronics Sales Co. v. Microsemiconductor Corp., 610 F. Supp. 550, 556 (D. Minn. 1985); Hartford Elec. Supply Co. v. Allen-Bradley Co., No. CV 96562061S, 1997 WL 297256, at *3, (Conn. Super. Ct. May 28, 1997) *aff'd*, 736 A.2d 824 (Conn. 1999); Holiday Inns Franchising, Inc. v. Branstad, 537 N.W.2d 724, 728–29 (Iowa 1995): Kubis & Perszyk Assocs., Inc. v. Sun Microsystems, Inc., 680 A.2d 618, 626 (N.J. 1996); McDonald's Corp. v. Markim Inc., 306 N.W.2d 158, 162 (Neb. 1981); David L. Cahn & Jeffrey S. Fabian, *Mobility, the Home, and the Scope and Application of State Franchise Relationship and Termination Laws*, 30 FRANCHISE L.J. 107, 107 (2010); Curran, *supra* note 17, at 152; Palmer, *supra* note 17, at 491; Pitegoff, *supra* note 17, at 289.

[19] Lagarias & Boulter, *supra* note 17, at 143–44; Pitegoff & Garner, *supra* note 16, at 187–88; Pitegoff, *supra* note 17, app. E at 329–31.

[20] *See* ARK. CODE ANN. § 4-72-209 (2012); CAL. BUS. & PROF. CODE §§ 20020–21 (West 2012); HAW. REV. STAT. § 482E-6(H) (2012); 815 ILL. COMP. STAT. 705/19 (2012); IOWA CODE §§ 523H.7(1), 537A.10(7)(c) (2012); MINN. STAT. § 80C.14(3)(b) (2012); MISS. CODE ANN. § 75-24-57 (2012); MO. REV. STAT. § 407.405(1) (2012); NEB. REV. STAT. § 87-404; N.J. STAT. ANN. § 56:10-5; N.D. CENT. CODE § 51-20.1-03 (2012); P.R. LAWS ANN. tit. 10, § 278a (2008); R.I. GEN. LAWS § 6-50-4; WASH. REV. CODE § 19.100.180(2)(j) (2012); WIS. STAT. § 135.03.

[21] *See* ARK. CODE ANN. § 4-72-206(2); CAL. CORP. CODE §§ 31220, 31302.5 (West 2012); HAW. REV. STAT.§ 482E-6(2)(A); 815 ILL. COMP. STAT. 705/17; IOWA CODE § 523H.9; MICH. COMP. LAWS § 445.1574(g) (2012); MINN. R. 2860.4400(A) (2012); NEB. REV. STAT. § 87-406(2); N.J. STAT. ANN. § 56:10-7(b); R.I. GEN. LAWS § 19-28.1-16.

[22] *See* CAL. BUS. & PROF. CODE § 20040 (West 2012); MICH. COMP. LAWS § 445.1527; MINN. STAT. § 80C.21; R.I. GEN. LAWS § 19-28.1-14.

[23] *See* HAW. REV. STAT. § 482E-6(2)(E); IND. CODE § 23-2-2.7-1(2) (2012); IOWA CODE § 523H.6(1); MINN. R. 2860.4400(c); WASH. REV. CODE § 19.100.180(2)(f).

[24] *See, e.g.*, IND. CODE ANN. § 23-2-2.7-1; PHILIP F. ZEIDMAN, LEGAL ASPECTS OF SELLING AND BUYING, § 7.6 (3d ed. 2011); Robert W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 257 (2010); Palmer, *supra* note 17, at 491; Pitegoff, *supra* note 17, at 307.

[25] *See, e.g.*, ARK. CODE ANN. §§ 4-72-201 to -10; CAL. BUS. & PROF. CODE § 20000 (West 2012); CONN. GEN. STAT. § 42-133e (2012); DEL. CODE ANN. tit. 6, § 2551 (2012); HAW. REV. STAT. §§ 482E-1–12; 815 ILL. COMP. STAT. 705/1–44; IND. CODE §§ 23-2-2.5-1 to -51; IOWA

In addition, several states have industry-specific franchise relationship laws.[26] These industry-specific statutes relate to automobile dealerships,[27] alcoholic beverages,[28] farm equipment,[29] petroleum,[30] and office products,[31] among other industries.[32]

At the federal level, several general franchise relationship bills have been introduced, but all were rejected.[33] For example, a federal franchise relationship law of general application was proposed in 1971; however, no such law has ever been adopted.[34] In 1992, former Democratic Congressman James H. Scheuer introduced a franchise relationship bill which ultimately was not adopted.[35] Similarly, former Democratic Congressman John J. LaFalce in 1993 and 1995, and Republican Congressman Howard Coble in 1998 and 1999, each proposed franchise relationship bills that did not pass.[36] In addition, in 2007, the Federal Trade

CODE §§ 523H.1–523H.17; MICH. COMP. LAWS §§ 445.1501–46; MINN. STAT. §§ 80C.01–30; NEB. REV. STAT. §§ 87-401–10; N.J. STAT. ANN. §§ 56:10-1–15; S.D. CODIFIED LAWS §§ 37 5A-1–87 (2006); TENN. CODE ANN. §§ 47-25-1501–11 (2012); VA. CODE ANN. §§ 13.1-557–74 (2012); WASH. REV. CODE §§ 19.100.010–940; WIS. STAT. § 135.01–07. The District of Columbia, Puerto Rico, and the Virgin Islands also have franchise relationship laws. *See* D.C. CODE § 34-1731.06 (2012); P.R. LAWS ANN. tit. 10, §§ 278–278d; V.I. CODE ANN. tit. 12A, § 132 (2012).

[26] *See* Ernest A. Braun, *Policy Issues of Franchising*, 14 SW. U. L. REV. 155, 216 (1984); Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1512 n.29 (1990).

[27] *See, e.g.*, CAL. VEH. CODE §§ 3060–69 (West 2012); IOWA CODE §§ 322A.1–322A.17; N.M. STAT. ANN. §§ 57-16-1 to -16 (2012); *see also* ZEIDMAN, *supra* note 24, app. N (providing a detailed list of state motor vehicle franchise laws).

[28] *See, e.g.*, 815 ILL. COMP. STAT. 720/1–720/9; KAN. STAT. ANN. § 41-410 (2012); MICH. COMP. LAWS § 436.30b (1993) (repealed 1998); N.C. GEN. STAT. §§ 18B 1200–16 (2012).

[29] *See, e.g.*, KAN. STAT. ANN. §§ 16-1201–16-1208 (2012) (farm equipment statute); *see also* ZEIDMAN, *supra* note 24, app. Q (providing a detailed list of state farm equipment franchise laws).

[30] *See, e.g.*, N.Y. GEN. BUS LAW §§ 199-a to -n (McKinney 2012) (sale of motor vehicle fuel franchises); *see also* ZEIDMAN, *supra* note 24, at Appendix O (providing a detailed list of state petroleum franchise laws).

[31] *See, e.g.*, HAW. REV. STAT. 481G-1 to -8 (2012) (exempting office product machine franchises from laws regulating business relationships in the industry).

[32] *See* Pitegoff & Garner, *supra* note 16, at 186; DON T. HIBNER, JR., AM. BAR ASS'N, ANTITRUST SECTION: MONOGRAPH NO. 17, FRANCHISE PROTECTION: LAWS AGAINST TERMINATION AND THE ESTABLISHMENT OF ADDITIONAL FRANCHISES 16–17 (1990).

[33] *See* Braun, *supra* note 26, at 203–04; Robert W. Emerson, *Franchise Terminations: Legal Rights and Practical Effects When Franchisees Claim the Franchisor Discriminates*, 35 AM. BUS. L.J. 559, 563 (1998). *See generally* Donald P. Horwitz & Walter M. Volpi, *Regulating the Franchise Relationship*, 54 ST. JOHN'S L. REV. 217, 218 (1980) ("[L]egislation regulating the franchise relationship . . . has frequently been proposed in Congress.").

[34] Pitegoff & Garner, *supra* note 16, at 185.

[35] Federal Fair Franchising Practices Act of 1992, H.R. 5961, 102nd Cong. (1992).

[36] Small Business Franchise Act of 1999, H.R. 3308, 106th Cong. (1999); Small Business Franchise Act of 1998, H.R. 4841, 105th Cong. (1998); Federal Fair Franchise Practices Act, H.R. 1717, 104th Cong. (1995); Federal Fair Franchise Practices Act, H.R. 1316, 103rd Cong.

Commission (FTC) considered but eventually rejected federal regulation of the franchise relationship.[37] To date, there is no franchise relationship law of general application in existence.[38]

While broad legislative efforts have failed at the federal level, franchisees in certain industries have been successful in obtaining two central federal industry-specific relationship laws.[39] The first federal law specifically regulating franchise relationships was the Automobile Dealers' Franchise Act, commonly known as the Dealers' Day in Court Act (ADDCA).[40] Broadly speaking, the ADDCA provides that the franchisor must act in "good faith," not only in performing the franchise contract, but also in terminating the contract.[41] In 1978, Congress adopted another federal law, the Petroleum Marketing Practices Act (the PMPA), which sets forth procedures that a gas station franchisor must follow before it may terminate or refuse to renew a franchisee.[42]

III. THE FRANCHISOR ADVOCATES' VIEW

Franchisor advocates suggest that franchisees do not need any special legal protection against franchisor abuses under franchise relationship laws or other legal regimes.[43] To begin with, franchisor advocates assume that franchisees are sophisticated business

(1993).

37 Pitegoff & Garner, *supra* note 16, at 186.

38 *See* Emerson, *supra* note 33, at 577; Palmer, *supra* note 17, at 491; Pitegoff, *supra* note 17, at 289; Pitegoff & Garner, *supra* note 16, at 185.

39 Pitegoff & Garner, *supra* note 16, at 186.

40 Automobile Dealers' Franchise Act (Automobile Dealers' Day in Court Act), 15 U.S.C. §§ 1221–25 (2006); *see, e.g.*, H.C. Blackwell Co. v. Kenworth Truck Co., 620 F.2d 104, 106 (5th Cir. 1980) (identifying the relevant statute as the "Automobile Dealers' Franchise Act"); Woodard v. Gen. Motors Co., 298 F.2d 121, 124–25, 124 n.1 (5th Cir. 1962).

41 15 U.S.C. § 1222 (2006).

42 Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801–06, 2821–24, 2841 (2006).

43 *See Report of the American Bar Association Section of Antitrust Law on Proposed Small Business Franchise Act*, A.B.A. SEC. ANTITRUST REP. cmt. 24, *available at* http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment025.htm (last visited Jan. 15, 2013) [hereinafter ABA REPORT]; James A. Brickley et al., *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101, 130 (1991); Mary deLeo, *Emasculating Goliath: Did* Postal Instant Press v. Sealy *Strike an Unfair Blow at the Franchising Industry?*, 25 W. ST. U.L. REV. 117, 170–72 (1997); Christopher R. Drahozal, *"Unfair" Arbitration Clauses*, 2001 U. ILL. L. REV. 695, 765–67 (2001); Horwitz & Volpi, *supra* note 33, at 276–78; William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 FRANCHISE L.J. 23, 31 (2008); Pitegoff, *supra* note 17, at 319–20; Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 299–300 (1993); Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223, 231–32 (1978).

people.[44] As Larry Ribstein explains, in franchise contracts "the price is set in each case by negotiations among sophisticated and knowledgeable parties."[45] Similarly, Christopher Drahozal argues that "franchisees are much closer to the sophisticated, well-informed individual . . . than are consumers or employees, and should be treated accordingly."[46]

Franchisor advocates further believe that since franchisees are sophisticated business people, they consider all relevant information in order to make a well-informed choice before signing a franchise contract. As William Killion, a long-time franchisor attorney and past Editor-in-Chief of the Franchise Law Journal explains, franchisees today have a wealth of information available to them before they sign the franchise agreement: "[They] have all of the information that legislators and regulators have found they need to make an informed decision."[47]

Additionally, franchisor advocates argue that since franchisees consider all of the relevant information, they specifically read the Franchise Disclosure Document (FDD), which must be provided to franchisees by the franchisor before signing the franchise agreement, according to the regulations of the Federal Trade Commission.[48] The FDD includes information which arguably warns franchisees against potential abuses by the franchisor. In particular, the FDD includes data on pending and prior lawsuits involving the franchisor.[49] Furthermore, the FDD must include, in a specified tabular format, the provisions of the franchisee

[44] Killion, *supra* note 43, at 30.

[45] Ribstein, *supra* note 43, at 257.

[46] Drahozal, *supra* note 43, at 766. *See also* Thomas J. Chinonis, *Implied Covenant of Good Faith: A Two-Way Street in Franchising*, 11 DEPAUL BUS. L.J. 229, 243 (1998) ("With the widespread familiarity and popularity of franchising, franchisees also know better what to look for and what to expect in a typical franchise relationship."); deLeo, *supra* note 43, at 171 ("Today's franchisees are more savvy, more educated, more likely to come from a business background and therefore more likely to be experienced in assessing risks and making informed decisions accordingly."); Christopher R. Drahozal & Quentin R. Wittrock, *Is There a Flight from Arbitration?*, 37 HOFSTRA L. REV. 71, 87 (2008) ("[F]ranchisees are business people, and at least some franchisees are very sophisticated business people—including publicly-traded companies."); Horwitz & Volpi, *supra* note 33, at 248 n.123 ("The modern franchisee is no longer a no-experience novice. The typical new franchisee, in many industries, is a professional franchisee—compared with the amateur franchisee of the 1950's, and the 1960's."); Pitegoff, *supra* note 17, at 315–16 n.111 ("Today's franchisee is frequently a trained and well-financed businessman, with a good understanding of the franchise relationship and his role in it.").

[47] Killion, *supra* note 43, at 31.

[48] 16 C.F.R. § 436 (2012).

[49] FED. TRADE COMM'N, THE FRANCHISE RULE COMPLIANCE GUIDE 34–41 (2008), *available at* http://business.ftc.gov/sites/default/files/pdf/bus70-franchise-rule-compliance-guide.pdf.

agreement dealing with termination and arbitration.[50] In addition, when the franchisor does not offer an exclusive territory to the franchisor, the FDD must include a prescribed statement underscoring that fact and a warning about the consequences of purchasing a non-exclusive territory.[51] Since the FDD includes data that may warn franchisees against franchisors potential abuses, the FDD—according to franchisor advocates—guarantees the franchisee access to the basic information necessary to reach an informed decision before entering a franchise contract.[52] As Donald Horwitz and Walter Volpi, who represented the McDonald's Corporation, explain, "full disclosure enables prospective franchisees to make a reasoned evaluation of the potential risks and benefits of franchising."[53] In a similar vein, George Hay argues that franchise disclosure documents operate "to ensure that prospective investors are given information about the likely costs and revenues of a particular franchise opportunity in order to help them make an informed choice."[54]

As sophisticated business people who consider all of the relevant information, franchisees are presumed—by franchisor advocates—to be able not only to read the FDD, but also to compare systematically the various franchise contracts and disclosure documents offered by different franchisors. As Thomas Pitegoff, Chair of the Franchise Committee of the New York State Bar Association's Business Law Section, argues, "[p]rospective franchisees now have *hundreds* of franchises from which to choose. If the terms of one franchise are too onerous . . . the prospective franchisee may go elsewhere . . . ."[55] The American Bar Association Section of Antitrust Law, too, explains, that "[a]rmed with . . . [disclosure documents] franchisees can make informed choices

[50] *Id.* at 80–83.

[51] *Id.* at 72–73.

[52] *See* Killion, *supra* note 43, at 29.

[53] Horwitz & Volpi, *supra* note 33, at 217, 249.

[54] George A. Hay, *Is the Glass Half-Empty or Half-Full?: Reflections on the* Kodak *Case*, 62 ANTITRUST L.J. 177, 188 (1993); *see also* Brickley et al., *supra* note 43, at 111; *see also* Killion, *supra* note 43, at 28 ("[F]ranchisees now have through the typical franchise disclosure document detailed information about the franchise opportunity, the very information a number of states and the FTC have determined will allow the franchisee to make an informed buying decision."); Pitegoff, *supra* note 17, at 314; deLeo, *supra* note 43, at 171 ("Disclosure laws ensure potential franchisees are advised of the nature and scope of the franchise agreement prior to signing."); ABA REPORT, *supra* note 43, at 20. *See generally* Drahozal, *supra* note 43, at 766–67 (discussing franchisees' contract term shopping due to sophisticated business knowledge); Drahozal & Wittrock, *supra* note 46, at 87 (discussing the sophistication of franchisees as business people).

[55] Pitegoff, *supra* note 17, at 315 (emphasis added).

among the range of franchise alternatives then available to them."[56] Beyond their ability to compare the various franchise contracts and disclosure documents, according to franchisor advocates, franchisees, as sophisticated business people, are able to consult with a specialized franchise attorney regarding the terms of the franchise contract before signing it. As Larry Ribstein states, franchisees "have the ability and incentive to read the contract carefully or hire an attorney to do so."[57]

Ultimately, franchisor advocates conclude that since franchisees read disclosure documents, compare various franchise contracts and disclosure documents, and are able to consult with a specialized lawyer, they do not deserve any special legal protection under franchise relationship laws or a similar legal regime.[58] Such protection, in fact, would interfere with the franchisor-franchisee free-market relationship. As Paul Rubin explains, "[w]hat is involved here is a general freedom-of-contract issue . . . ."[59]

IV. THE CRITIQUE

The franchisor advocate's assumption that franchisees consider all relevant information in order to make a well-informed choice before signing a franchise contract is questionable. New franchisees that join a franchise network normally lack prior business

[56] ABA REPORT, *supra* note 43, at 20. *See* Drahozal, *supra* note 43, at 766–67; *see* Drahozal & Wittrock, *supra* note 46, at 87; Hay, *supra* note 54, at 188 ("But whatever one might argue about the sophistication, or lack thereof, of copy machine purchasers, the argument seems far less plausible when applied to prospective franchisees. There are literally *thousands* of franchise opportunities available to prospective investors . . . .") (emphasis added); Horwitz & Volpi, *supra* note 33, at 246; Killion, *supra* note 43, at 30 ("FRANdata estimates that there are more than *2,900* active franchise systems today. . . . With such a broad variety of franchisors competing with each other for franchise opportunities, it is difficult to imagine that . . . franchisees have little alternative but to give in to the contractual dictates of an overpowering franchisor.") (emphasis added); *see also* Chinonis, *supra* note 46, at 243 ("Since prospective franchisees now have *hundreds* of franchises from which to choose, they can refuse to enter agreements that may not appear fair to franchisees.") (emphasis added).

[57] Ribstein, *supra* note 43, at 257. *See also* Drahozal, *supra* note 43, at 766–67; Horwitz & Volpi, *supra* note 33, at 248.

[58] *See* Killion, *supra* note 43, at 31; Pitegoff, *supra* note 17, at 319–20; deLeo, *supra* note 43, at 171–72. *See generally* ABA REPORT, *supra* note 43, § 1(C) (detailing why the Antitrust Section believed Small Business Franchise Act of 1998 should not be adopted). *But see* Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care Toward Its Franchisees*, 72 N.C. L. REV. 905 (1994) (arguing that the franchise relationship affords franchisors so much discretionary power that for many franchise contract clauses the franchisor should be held to a higher standard of care than simply the implied covenant of good faith and fair dealing).

[59] Rubin, *supra* note 43, at 232.

ownership experience.[60] This lack of experience presents significant cognitive obstacles for novice franchisees when attempting to consider all of the relevant information before acquiring ownership of a franchise unit.[61]

A. New Franchisees Lack Prior Business Ownership Experience

1. Explanation

New franchisees joining franchise networks typically do not possess prior business ownership experience, let alone franchise unit ownership experience.[62] The central reason for this phenomenon is the *nature* of the franchise business format, which attracts individuals of limited business ownership experience. As will be explained in greater detail below, individuals with no prior business ownership experience are attracted to the franchise business format because it provides the franchisee with the following: (1) an opportunity to join an already established business system; (2) site selection assistance; (3) initial training; (4) ongoing training; and (5) detailed operational manuals.[63]

First, as mentioned, the franchise business format provides novice franchisees with an opportunity to join an already established business system.[64] Because a franchising system provides a business formula developed through previous high-risk yet successful experiences, many of the unavoidable business mistakes that plague the independent business owner have already

[60] *See infra* Part IV.A.

[61] *See infra* Part IV.B.

[62] *See* Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 961–62 (1990); Elizabeth C. Spencer, *Consequences of the Interaction of Standard Form and Relational Contracting in Franchising*, 29 FRANCHISE L.J. 31, 32 (2009). For empirical support, see *infra* Part IV.B.

[63] RICHARD J. JUDD & ROBERT T. JUSTIS, FRANCHISING: AN ENTREPRENEUR'S GUIDE 33–34 (4th ed. 2008); MARTIN MENDELSOHN, THE GUIDE TO FRANCHISING 48 (7th ed. 2004); Arthur I. Cantor, *Federal/State Franchise and Dealership Laws*, 677 PLI/Corp. 105, 114–15 (1990) (PLI Corp. Law & Prac. Course Handbook Series No. 677, 1990); Chinonis, *supra* note 46, at 238; Hess, *supra* note 16, at 338–39; John Stanworth & James Curran, *Colas, Burgers, Shakes, and Shirkers: Towards a Sociological Model of Franchising in the Market Economy*, 14 J. BUS. VENTURING 323, 334 (1999); Mika Tuunanen & Kimmo Hyrsky, *Entrepreneurial Paradoxes in Business Format Franchising: An Empirical Survey of Finnish Franchises*, 19 INT'L SMALL BUS. J. 47, 49 (2001); Anna Watson & John Stanworth, *Franchising and Intellectual Capital: A Franchisee's Perspective*, 2 INT'L ENTREPRENEURSHIP & MGMT. J. 337, 340 (2006); deLeo, *supra* note 43, at 122, 123–24.

[64] deLeo, *supra* note 43, at 123–24; Hess, *supra* note 16, at 338–39; Chinonis, *supra* note 46, at 238.

been overcome in the franchise system.[65] Thus, by becoming a part of an established system, the inexperienced franchisee reduces his overall risk of failure.[66] "This risk diminishment allows [a novice] franchisee to enter a field which he or she has no previous [experience with an apparently increased chance of business success]."[67]

Under the franchise business format, the inexperienced franchisee often also receives site selection assistance. Franchisors frequently "prepare a list of factors to be investigated prior to [selecting the site for the new franchised unit]."[68] These factors may include "economic strength and potential of a particular region . . . availability of transportation for supplies . . . demographic characteristics within the community . . . traffic ingress and egress at sites [under consideration]; land development and construction costs, and location of primary [business] competitors . . . ."[69] The franchisors will assist the inexperienced franchisee to select an appropriate site, using their established criteria for site selection.[70]

The franchise business format provides to novice franchisees not only assistance in site selection, but also an initial training program.[71] Normally, an inexperienced franchisee will receive initial training on all functions of operating the business, including finance, marketing, business operations, and management of personnel.[72] More specifically, the newcomer franchisee will be trained on how to develop and read a balance sheet and an income statement, how to use a cash register, how to recruit, select and train employees, and how to control inventory.[73] Indeed, empirical evidence shows that initial training represents a vital motivating factor for franchisees in the decision to purchase a franchised outlet. To illustrate, Scott Weaven and Lorelle Frazer adopted a qualitative methodology to examine the motivational incentives driving the choice to enter the franchising business from the franchisee's

[65] MENDELSOHN, *supra* note 63, at 47–48; deLeo, *supra* note 43, at 123–24.

[66] deLeo, *supra* note 43, at 123–24.

[67] deLeo, *supra* note 43, at 124; Hess, *supra* note 16, at 339.

[68] JUDD & JUSTIS, *supra* note 63, at 219.

[69] *Id.* at 219–20.

[70] MENDELSOHN, *supra* note 63, at 96.

[71] *See* JUDD & JUSTIS, *supra* note 63, at 21, 34 (stating that 98.3% of franchisors offer initial training).

[72] *See id.* at 525; MENDELSOHN, *supra* note 63, at 94–95; Robert T. Justis & Peng S. Chan, *Training for Franchise Management*, 29 J. SMALL BUS. MGMT. 87, 89 (1991); Stanworth & Curran, *supra* note 63, at 334.

[73] *See* JUDD & JUSTIS, *supra* note 63, at 218–19 tbl. 8-2.

perspective.[74] "The sample was made up of current franchisees within the McDonald's franchise system."[75] According to the study, "most single unit franchisees [claimed] that . . . initial training was a [primary] motivation in the decision to [purchase a franchise unit]."[76] "Franchising was perceived [by franchisees] as an easier method of entering self-employment in areas in which [they] had limited prior [business] experience."[77]

In addition, the franchise business format often provides inexperienced franchisees with ongoing training during the franchise relationship. Such training may cover "marketing updates, industry trends, new product[s] and service[s] developments . . . ."[78] "Field representatives play an important role in the delivery of [ongoing] training. They often work directly with [novice] franchisee[s] at the business site, providing expert [consultation], [offering] on-the-spot management and operational suggestions [to franchisees], . . . [and supplying] video or audio materials" for inexperienced franchisees."[79]

Frequently, inexperienced franchisees also receive detailed operational manuals. These manuals "describe each major function and operating procedure of the business."[80] They often include detailed instructions on topics such as quality standards, warranties and replacement practices, customer relations and service, inventory loss prevention, and maintenance control.[81]

It is worth noting that new franchisees regularly lack prior business experience not only because of the *nature* of the franchise

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[74] *See* Scott Weaven & Lorelle Frazer, *Investment Incentives for Single and Multiple Unit Franchisees*, 9 QUALITATIVE MKT. RES. INT'L J. 225, 230, 233 (2006).

[75] *Id.* at 228, 229.

[76] *Id.* at 233.

[77] *Id.* at 233. *But cf.* Alden Peterson & Rajiv P. Dant, *Perceived Advantages of the Franchise Option from the Franchisee Perspective: Empirical Insights from a Service Franchisee*, 28 J. SMALL BUS. MGMT. 46, 53, 58 (1990) (concluding that while the availability of training may resolve a new franchisee's concerns, arising from a lack of prior business experience, "the motivations that drive franchisees into choosing the franchise format may not be as homogenous as supposed").

[78] JUDD & JUSTIS, *supra* note 63, at 527. Robert W. Emerson, *Franchise Contract Interpretation: A Two-Standard Approach* 55 (Jan. 30, 2013) (unpublished manuscript) (on file with author) (noting that a 2010 survey of franchise contracts found that 95% provide that the franchisor performs ongoing consultation services for the franchisee after the initial training).

[79] JUDD & JUSTIS, *supra* note 63, at 527.

[80] *Id.* at 213; MENDELSOHN, *supra* note 63, at 62; Emerson, *supra* note 78, at 55 (noting that 96% of surveyed franchise contracts referred to operating manuals, which the franchisor had the right to revise).

[81] JUDD & JUSTIS, *supra* note 63, at 214–15. *See generally* MENDELSOHN, *supra* note 63, at 61–66 (describing items that should be included in a franchise manual).

business format, but also due to the fact that franchisors tend to prefer to contract with franchisees with no prior business experience.[82] Inexperienced franchisees, as opposed to those with experience, are relatively easy to control.[83] They are more likely to adapt themselves to the standard system procedures and methods of the franchise system,[84] while they are less likely to use the franchisor's know-how, trade secrets, and confidential information in competition with it.[85] They are also less likely to be a difficult opponent in the event of any dispute with the franchisor.[86]

2. Empirical Evidence

Empirical evidence shows that new franchisees that join a franchise network are unlikely to possess franchise unit ownership experience, or even any prior business ownership. The results of Kimberly Morrison's research examining, among other things, the personal characteristics of franchisees, illustrate this phenomenon.[87] Using a mailed questionnaire, data were obtained from 307 U.S. franchisees from four industries: "restaurant, business aids [sic] and services, automotive products and services, [and] non-food retailing."[88] The sample was randomly compiled by a research firm and was composed of franchisees from forty-six

[82] Lorelle Frazer, *Causes of Disruption to Franchise Operation*, 54 J. BUS. RES. 227, 228 (2001); José M. Ramírez-Hurtado et al., *Criteria Used in the Selection of Franchisees: An Application in the Service Industry*, 5 SERV. BUS. 47, 53 (2011).

[83] *See* MENDELSOHN, *supra* note 63, at 81.

> [S]ome franchisors believe that the person with experience of their type of business will be more difficult to train in the franchisor's particular methods. . . . On the other hand, there can be some businesses where a background knowledge of the trade or technical know-how is essential and since it cannot be taught within an economically viable time frame the prospective franchisee must have the requisite basis knowledge.

Id.

[84] *Id.*; Frazer, *supra* note 82, at 228; JUDD & JUSTIS, *supra* note 63, at 34; Steven C. Michael, *Investments to Create Bargaining Power: The Case of Franchising*, 21 STRAT. MGMT. J. 497, 501 (2000).

[85] *See generally* MENDELSOHN, *supra* note 63, at 80–81 (corporate franchisees).

[86] *See generally id.* at 81 (corporate franchisees). Indeed, empirical evidence indicates that franchisors prefer to contract with inexperienced franchisees. According to Judd and Justis, only 10.6% of U.S. franchisors in the employment and personal services franchise sector require prior industry experience from their new franchisees. JUDD & JUSTIS, *supra* note 63, at 18 tbls.1, 2. *See also* Ramírez-Hurtado et al., *supra* note 82, at 58, 59 tbl.6 (noting that previous experience operating a related business was one of the attributes least valued by franchisors in the service sector).

[87] *See* Kimberley A. Morrison, *An Empirical Test of a Model of Franchisee Job Satisfaction*, 34 J. SMALL BUS. MGMT. 27, 28 (1996).

[88] *Id.* at 29, 30.

states.[89] According to the study, "only 20 percent of the sample had actually been business owners before becoming franchisees."[90]

Another empirical study conducted by Alden Peterson and Rajiv Dant shows even more strongly that most new franchisees lack prior business ownership experience.[91] Using a mailed questionnaire, data were obtained from seventy-four random U.S. franchisees of a major nationwide franchise system in the service industry.[92] According to the study, only 6.7% of the sample had owned an independent business prior to joining the franchise system.[93]

Interestingly, empirical studies show that franchisees often lack not only prior business ownership experience, but also experience in the same business as their franchise. For example, Robert L. Anderson, Clarence Condon, and John Dunkelberg conducted an empirical study among U.S. franchisees.[94] Using a mailed questionnaire, data were obtained from sixty-one franchisees.[95] According to the results of the study, "only 38 percent [of the franchisees] had worked in the same business as their franchise."[96] Patrick Kaufmann's study produced a similar outcome, where among sixty-three U.S. franchisees who completed his questionnaires, approximately "70% had purchased franchises in business sectors in which they had no specific work experience."[97]

What is more, there is empirical evidence that lack of prior business experience is not unique to U.S. franchisees and is in fact a global phenomenon, prototypical to the *nature* of the franchise business format. For instance, Russell Knight conducted an empirical study among Canadian franchisees in order to examine, among other things, their personal characteristics.[98] Using a mailed questionnaire, data were obtained from 105 franchisees in a variety of well-known franchises across Canada.[99] According to the

[89] *Id.*

[90] *Id.* at 30.

[91] Peterson & Dant, *supra* note 77, at 50 tbl.1.

[92] *Id.* at 49.

[93] *Id.* at 50.

[94] Robert L. Anderson et al., *Are Franchisees "Real" Entrepreneurs?*, 4 J. BUS. & ENTREPRENEURSHIP 97, 99 (1992).

[95] *Id.*

[96] *Id.* at 100.

[97] Patrick J. Kaufmann, *Franchising and the Choice of Self-Employment*, 14 J. BUS. VENTURING 345, 353, 358 (1999).

[98] Russell M. Knight, *The Independence of the Franchisee Entrepreneur*, 22 J. SMALL BUS. MGMT. 53, 54 (1984).

[99] *Id.*

results of the study, 72% of franchisees had no previous business management experience before joining the franchise system.[100] In another Russell Knight study, conducted with a similar sample, 89% of Canadian franchisees had no previous experience in franchising before joining the franchise system.[101]

Lack of prior business experience among franchisees was also documented in Australia. To illustrate, Nerilee Hing conducted an empirical study that included an examination of franchisees' personal traits.[102] Data were obtained from nine restaurant franchise companies and 127 of their franchisees.[103] The study's findings determined that most franchisees had no prior entrepreneurial business experience.[104] Similarly, Scott Weaven and Carmel Herington adopted a qualitative methodology for examining the personal characteristics of Australian female franchisees, among other factors.[105] According to the study, most female franchisees had limited business experience.[106]

Indeed in England, studies also found a general lack of prior business experience among franchisees. For example, John Stanworth conducted an empirical study examining various aspects of U.K. franchising including the franchisees' personal characteristics.[107] Data were obtained from 249 franchisees using a mailed questionnaire, followed by in-depth interviews.[108] The franchisees were chosen from a variety of business sectors, including fast food, dry cleaning and hygiene services, and printing services.[109] The study yielded the result that two-thirds of franchisees had no self-employment experience prior to joining the franchise system.[110]

Additionally, lack of prior business experience among franchisees was documented in Spain. Jose Ramírez-Hurtado and Bernardino

[100] *Id.* at 56.

[101] Russell M. Knight, *Franchising from the Franchisor and Franchisee Points of View*, 24 J. SMALL BUS. MGMT. 8, 9–10 (1986).

[102] Nerilee Hing, *Franchisee Satisfaction: Contributors and Consequences*, 33 J. SMALL BUS. MGMT. 12, 13 (1995).

[103] *Id.* at 15, 17.

[104] *Id.* at 19.

[105] Scott Weaven & Carmel Herington, *Female Franchisors: How Different Are They from Female Independent Business Owners?*, 2006 ACAD. MARKETING SCI. REV. 1, 3.

[106] *Id.* at 13.

[107] John Stanworth, *The Franchise Relationship: Entrepreneurship or Dependence?*, 4 J. MARKETING CHANNELS 161, 162 (1995).

[108] *Id.*

[109] *Id.*

[110] *Id.* at 163.

Quattrociocchi conducted an empirical study among Spanish franchisees, which obtained data using a mailed questionnaire from 220 Spanish franchisees.[111] Similar to the studies conducted in other countries, 60.7% of the franchisees surveyed had no previous business ownership experience.[112]

B. Inexperienced Franchisees Ignore Relevant Information

Inexperienced franchisees tend to sign franchise contracts on the basis of inadequate pre-investment investigation and evaluation.[113] More specifically, franchisees—in contrast with the franchisor advocates' view—ignore franchise disclosure documents, avoid conducting a comparison between various franchise contracts and disclosure documents, and refrain from consulting with a specialized franchise attorney before signing the franchise agreement.[114] Below we will first provide a theoretical explanation for this phenomenon.[115] Second, we will present empirical evidence supporting the existence of the phenomenon.[116]

1. Explanation

A prospective franchisee who aspires to own a franchise unit usually needs to search for complex information about potential franchise opportunities. This information is business ownership oriented; namely, it deals with many financial and legal aspects that typify the ownership of a business. To begin with, it is necessary that a prospective franchisee estimate the sales revenue, costs, cash flow, net income, and loss of various franchise ownership options.[117] In addition, the franchisee must investigate the legal risks involved in the relationship between the franchisee's unit and its employees, suppliers, franchisor, and customers.[118] As will be explained in more detail below, since the vast majority of prospective franchisees lack prior business ownership experience,

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[111] Jose M. Ramírez-Hurtado & Bernardino Quattrociocchi, *An Update of the Franchisee Motivations: A Study in Spain*, 4 J. APPLIED ECON. SCI. 210, 212 (2009).

[112] *Id.* at 213.

[113] *See* Lorelle Frazer et al., *Power and Control in the Franchise Network: An Investigation of Ex-Franchisees and Brand Piracy*, 23 J. MARKETING MGMT. 1037, 1048 (2007).

[114] *See infra* notes 142–46 and accompanying text.

[115] *See infra* Part IV.B.1.

[116] *See infra* Part IV.B.2.

[117] *See* THE FRANCHISE HANDBOOK: A COMPLETE GUIDE TO ALL ASPECTS OF BUYING, SELLING, OR INVESTING IN A FRANCHISE 100, 102–03 (2006).

[118] *Id.* at 39–41.

they will face significant cognitive obstacles when attempting to consider all of the relevant information before acquiring ownership of a franchise unit.[119] More specifically, the novice franchisee will face three cognitive obstacles: the unawareness problem, screening difficulty, and comprehension limitations.[120]

Novice franchisees, who have recently decided that they want to own a franchise, normally suffer from an unawareness problem. They are typically unaware of all the business and legal risks involved in owning a franchise unit.[121] Furthermore, inexperienced franchisees may be unaware of where to look for the most accurate and qualified information on franchise ownership.[122] As a result of franchisees' unawareness, they will be forced to invest major cognitive efforts in order to ascertain which risks are unknown to them and where to seek accurate information regarding those risks.[123] Such a task is extremely challenging, given that conducting a high-quality investigation into the matter demands that one knows enough to know what is not known.[124]

Not only do inexperienced franchisees face an unawareness problem but they must also cope with a screening difficulty. In particular, they must expend great cognitive efforts in order to differentiate between relevant and irrelevant business and legal information on franchise ownership, in which they most likely have never engaged.[125] Such a screening task presents a real challenge since novice franchisees who wish to make an optimal franchise investment decision must examine an overwhelming amount of complex information before signing a franchise contract. Specifically, at a preliminary stage the franchisee generally must invest time in the following steps[126]: reading complex franchise

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[119] *See infra* notes 148–65 and accompanying text.

[120] *See infra* notes 121–46.

[121] *See* Spencer, *supra* note 62, at 31.

[122] *See id.*

[123] *See* Hadfield, *supra* note 62, at 978 n.232 ("[I]nexperience of the franchisee . . . make[s] the identification of franchisor opportunism very difficult."). *See generally* Robert G. Lord & Karen J. Maher, *Alternative Information Processing Models and Their Implications for Theory, Research, and Practice*, 15 ACAD. MGMT. REV. 9, 14 (1990) (discussing differences in the way experts and novices process information).

[124] *See* Naomi Miyake & Donald A. Norman, *To Ask a Question, One Must Know Enough to Know What is Not Known*, 18 J. VERBAL LEARNING AND VERBAL BEHAV. 357, 357 (1979) ("[T]he ability of a person to think of an appropriate question on a topic matter is a complex function of the knowledge of that topic.").

[125] *See* Joseph W. Alba & J. Wesley Hutchinson, *Dimensions of Consumer Expertise*, 13 J. CONSUMER RES. 411, 419 (1987) (observing that the novices' lack of knowledge affects their ability to process available information).

[126] *See* BARBARA BESHEL, AN INTRODUCTION TO FRANCHISING 13–15 (2001), *available at*

directories,[127] reading articles in franchise business publications,[128] attending business trade shows and expositions,[129] and conducting related research on the internet.[130] Following this preliminary stage, the franchisee will have to contact selected franchisors in order to acquire detailed business and legal information regarding each individual franchise opportunity.[131] He or she will then receive a massive amount of material requiring business and legal analysis.[132] This material will include lengthy promotional items, operational items, and complex legal items including the FDD.[133] Upon receipt of detailed material on selected franchise opportunities, the franchisee may be required to take the following additional steps[134]: interview potential franchisors,[135] interview existing franchisees,[136] examine lengthy and complex franchise agreements, review audited financial statements, and conduct trade-area surveys.[137]

In addition to the screening difficulty, franchisees face comprehension obstacles at the pre-contractual stage. Again, most inexperienced franchisees lack an adequate base of knowledge on what it takes to own any business, let alone a franchise unit.[138] Specific to this context, they generally lack adequate knowledge of

http://www.franchise.org/uploadedFiles/Franchise_Industry/Resources/Education_Foundation/Intro%20to%20Franchising%20Student%20Guide.pdf.

[127] Famous franchise directories include: "The Franchise Opportunities Guide," "The Executives' Guide to Franchise Opportunities," "Bond's Franchise Guide," "The Franchise Annual," "Franchise Handbook," and "How Much Can I Make?" *Id.* at 13.

[128] Major relevant franchise business publications include: *Franchise Times*, *Franchising World*, and *Franchise Update*. *Id.*

[129] *Id.* at 14.

[130] *Id.*

[131] *Id.* at 14–16.

[132] *See* THE FRANCHISE HANDBOOK, *supra* note 117, at 34–35.

[133] *See id.* at 35, 37–43. The FDD is a complex document which contains, as required by the FTC's rules, twenty-three specific items of detailed information about the offered franchise, its officers, and other franchisees. *See FTC Issues Updated Franchise Rule*, FED. TRADE COMM'N (Jan. 23, 2007), http://www.ftc.gov/opa/2007/01/franchiserule.shtm.

[134] *See Navigate the Paper Trail*, ENTREPRENEUR (Jan. 21, 2001), http://www.entreprenuer.com/article/36392.

[135] Such interviews may include an examination of the following business aspects: franchisor business experience, the total investment required to setup and operate a franchise, franchisor training plans, franchisor products, franchisor advertisement and marketing methods and plans, and the franchisor's ongoing business support to its existing franchisees. *See* BESHEL, *supra* note 126, at 27–29.

[136] Such interviews may include an investigation of the following business aspects: level of training, quality of products or service, level and promptness of support, operations and quality of the operations manuals, earnings potential/claims, and any problems or difficulties with the franchisor. *See* BESHEL, *supra* note 126, at 30–31.

[137] *See Navigate the Paper Trail*, *supra* note 134.

[138] *See supra* note 82 and accompanying text.

franchise ownership terminology, the attributes of a franchise owned unit, criteria for evaluating a franchise system, and criteria for comparing different franchise systems.[139] Given this lack of knowledge, inexperienced franchisees find it difficult to comprehend and evaluate the complex legal and business data available to them at the pre-contractual stage.[140] Indeed, prospective franchisees often report that when they read legal FDDs, they are seized by a condition dubbed "MEGO—'My Eyes Glaze Over.'"[141]

Given the significant unawareness, screening and comprehension obstacles that novice franchisees face at the pre-contractual stage, they frequently discount important information already at that stage.[142] The dismissal of information occurs in order to simplify cognitively the complex pre-contractual investigation.[143] In the process of simplification, novice franchisees eliminate data from consideration on the basis of expediency rather than importance.[144] The incompetence of novice franchisees ultimately causes them to base their decisions on relatively "'shallow' aspects" that might be relatively quick and "easy to judge," such as franchise advertisements, newspaper articles, and franchise prices.[145] In

[139] *See supra* notes 87–97 and accompanying text; *see infra* notes 146–50 and accompanying text.

[140] *See generally* Merrie Brucks, *The Effects of Product Class Knowledge on Information Search Behavior*, 12 J. CONSUMER RES. 1, 3 (1985) (discussing how prior knowledge makes processing new information easier); Susan T. Fiske et al., *The Novice and the Expert: Knowledge-Based Strategies in Political Cognition*, 19 J. EXP. SOC. PSYCHOL. 381, 384–85 (1983) (explaining the advantages that experts have in comparison to novices); Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 726 (2011) (stating that novices often have trouble understanding necessary information due to a lack of expertise).

[141] Andrew A. Caffey, *Franchise Research Basics: How to Compare Similar Opportunities*, ALL BUS., http://www.allbusiness.com/franchises/buying-a-franchise/13420130-1.html (last visited Jan. 15, 2013).

[142] *See* Alba & Hutchinson, *supra* note 125, at 419. *See generally* John Kim et al., *Consumer Expertise and the Vividness Effect: Implications for Judgment and Inference*, 18 ADV. CONSUMER RES. 90, 90 (1991) ("Novices are likely to under-process information because they lack the cognitive resources required to construe the inferential implications of a large set of product-related information.").

[143] *See* Alba & Hutchinson, *supra* note 125, at 419 (explaining how novices often disregard important information because of their lack of knowledge).

[144] *See id*. (explaining that novices take this course because decision-making becomes easier).

[145] *See* Robert A. Baron & Michael D. Ensley, *Opportunity Recognition as the Detection of Meaningful Patterns: Evidence from Comparisons of Novice and Experienced Entrepreneurs*, 52 MGMT. SCI. 1331, 1340 (2006) (discussing how lack of experience leads to many failed business ventures); Meryl Paula Gardner, *Advertising Effects on Attributes Recalled and Criteria Used for Brand Evaluations*, 10 J. CONSUMER RES. 310, 312–13 (1983) (discussing the possible effects of advertisements on unfamiliar consumers); Akshay R. Rao & Kent B. Monroe, *The Moderating Effect of Prior Knowledge on Cue Utilization in Product Evaluations*,

contrast with the franchisor advocates' view, the significant cognitive obstacles faced by novice franchisees actually lead them to ignore franchise disclosure documents, avoid conducting a thorough comparison of various franchise contracts and disclosure documents, and refrain from consulting with a specialized franchise attorney before signing the franchise agreement.[146]

2. Empirical Evidence

There is ample empirical evidence supporting the conclusion that the significant cognitive obstacles that novice U.S. franchisees face at the pre-contractual stage lead them to ignore important data, as emphasized above.[147] For example, Kimberly Morrison's study, based on data collected by a mailed questionnaire from 307 U.S. franchisees in various industries, revealed that most franchisees ignored the franchise disclosure documents before investing in the franchise.[148] In addition, her study demonstrated that most franchisees did not consult with a lawyer before the signing of the franchise contract.[149] Likewise, as discussed previously, Anderson, Condon and Dunkelberg obtained data from sixty-one franchisees using mailed questionnaires.[150] According to their data, franchisees examined only an average of about three different franchise chains before selecting the franchise they own.[151] This fact stands in sharp contrast with franchisors advocates' assumption that franchisees possess the cognitive ability to compare numerous—it is safe to assume hundreds—of franchise contracts available at the market, before signing the franchise agreement.[152]

Furthermore, empirical studies show that the lack of adequate pre-investment investigation conducted by inexperienced franchisees is not unique to U.S. franchisees.[153] Franchisees' inadequate inquiry is a global phenomenon, which is derived from

15 J. CONSUMER RES. 253, 255 (1988) (explaining that consumers who aren't familiar with products could use price to judge quality); Fred Selnes & Sigurd Villads Troye, *Buying Expertise, Information Search, and Problem Solving*, 10 J. ECON. PSYCHOL. 411, 415, 425 (1989) (explaining that novice consumers make purchasing decisions based on simple factors like color and size).

146 *See infra* Part IV.B.2.

147 *See infra* notes 148–65 and accompanying text.

148 Morrison, *supra* note 87, at 30, 31 tbl.2.

149 *Id*. at 31 tbl.2.

150 Anderson, *supra* note 94, at 99.

151 *Id.* at 100.

152 *See supra* note 56 and accompanying text.

153 *See supra* notes 98–112 and accompanying text.

the fact that franchisees are, by their very nature, inexperienced.[154] To illustrate, Lorelle Frazer, Bill Merrilees, and Owen Wright, adopting a qualitative methodology, conducted in-depth interviews with eighteen Australian franchisors, current franchisees, and ex-franchisees.[155] One general conclusion that emerged from those interviews was that potential Australian franchisees who lack business experience tend to enter franchising on the basis of little or no research or investigation.[156] Likewise, Weaven, Frazer, and Giddings conducted in-depth interviews with twenty-four Australian franchising experts, such as franchisors, franchising consultants, franchising academics, franchise brokers, and mediators.[157] Most of the interviewees agreed that franchisees who had no prior business experience tended to seek relatively little advice from lawyers and other advisors prior to entering franchise agreements.[158] In a related study, John Stanworth, using mailed questionnaires and interviews, obtained data from 380 U.K. franchisees in a variety of industries.[159] According to his study, most of those franchisees who had consulted with advisors before signing the franchise contract were convinced that their advisors were not knowledgeable about franchising,[160] indicating that those franchisees who consulted with a legal advisor did not consult with a specialized one. Likewise, Mark Hatcliffe, Val Mills, David Purdy, and John Stanworth obtained data from 169 U.K. franchisees through mailed questionnaires and interviews.[161] According to their study, most franchisees seriously considered only one or two franchise chains before selecting the franchise they owned.[162]

Notably, these empirical studies—showing that novice franchisees around the world do not conduct adequate research and investigation prior to signing the franchise contract—confirm the anecdotal statements of various franchise specialists. Two such specialists, Andrew Selden and Rupert Barkoff, both of whom served as Chairs of the American Bar Association Forum on

[154] *See supra* notes 98–112 and accompanying text.

[155] Frazer et al., *supra* note 113, at 1044.

[156] *Id.* at 1048.

[157] Scott Weaven et al., *New Perspectives on the Causes of Franchising Conflict in Australia*, 22 ASIA PAC. J. MARKETING & LOGISTICS 135, 138 (2010).

[158] *Id.* at 148.

[159] John Stanworth, *Franchising and the Franchise Relationship*, 1 THE INT'L REV. RETAIL, DISTRIBUTION & CONSUMER RES. 175, 183–84 (1991).

[160] *Id.* at 186.

[161] Mark Hatcliffe et al., *Prospective Franchisees*, *in* 1 FRANCHISING IN BRITAIN REPORT 1, 4 (1995).

[162] *Id.* at 9 fig.9.

Franchising, state that "[m]any franchisees never consult a lawyer in the process of buying a franchise."[163] Similarly, Elizabeth Spencer, a scholar, specialized in franchising, states that "[m]any franchisees are unaware of the need for advice or are unable to secure the quality of advice they need."[164] Likewise, Keith Kanouse, a U.S. franchise attorney boasting twenty-two years of experience in franchise matters, claims that most prospective franchisees simply do not read franchise disclosure documents.[165]

V. CONCLUSION

As a key initial step in evaluating franchise regulation schemes, we must understand that the opposition to franchise relationship laws is based largely on the assumption that franchisees are sophisticated business people who (1) consider all relevant information, and (2) make a well-informed choice among the range of franchise alternatives available to them prior to signing a franchise contract.[166] However, empirical evidence raises much doubt regarding this assumption. In actuality, new franchisees are likely to be lacking prior business experience.[167] This lack of experience presents significant cognitive obstacles for novice franchisees at the pre-contractual stage. Inexperienced franchisees must invest significant cognitive efforts in identifying the risks about which they are ignorant and then finding accurate information on them.[168] Novice franchisees must also expend significant cognitive efforts in order to differentiate between relevant and irrelevant information.[169] Moreover, it is extremely difficult for unseasoned franchisees to comprehend the entirety of the data to which they are exposed in the pre-contractual process.[170] Given these cognitive obstacles, franchisees often discount important information at the pre-contractual stage. Franchisees

[163] Andrew C. Selden & Rupert M. Barkoff, *Counseling Franchisees*, *in* FUNDAMENTALS OF FRANCHISING 289, 291 (Rupert M. Barkoff & Andrew C. Selden, eds., 3d ed. 2008).

[164] Spencer, *supra* note 62, at 32; *See also* Robert W. Emerson, *Franchisees Without Counsel: Presumed Competent* 10–11 (Jan. 12, 2012) (unpublished manuscript) (on file with author) (detailing a 2008 survey of franchisor attorneys who found that a large number of prospective franchisees were completely unrepresented or were poorly counseled about federal and state franchise laws and the interpretation thereof).

[165] Roberta Maynard, *Choosing a Franchise*, 84 NATION'S BUS. 56, 62R (1996).

[166] *See supra* Part III.

[167] *See supra* Part IV.A.2.

[168] *See supra* note 120.

[169] *See supra* notes 125–37 and accompanying text.

[170] *See supra* notes 138–41 and accompanying text.

ignore disclosure documents, do not compare various franchise opportunities, and refrain from consulting with a specialized franchise attorney.[171] Given this reality, theoreticians and legislators interested in creating franchise laws that protect novice franchisees from possible opportunism by franchisors must cast doubt on the assumption that franchisees are sophisticated, well-informed business people and incorporate into their analyses a more representative conception of franchisee behavior. The assumption that franchisees consider all relevant information before signing a franchise contract has little theoretical or empirical support in actual practice, and thus the door is open to reconsidering the adoption of franchise relationship laws.

[171] *See supra* notes 142–46 and accompanying text.

INTERNATIONAL FRANCHISE ASSOCIATION

STATEMENT OF GUIDING PRINCIPLES

IFA INTERNATIONAL FRANCHISE ASSOCIATION

Franchising®
Building local businesses, one opportunity at a time.

For over fifty years the International Franchise Association has worked to educate franchisors and franchisees on beneficial methods and business practices to improve franchising.

Franchising is a dynamic and evolving method of expansion and business ownership. Beginning with the adoption in 1970 of the first franchise disclosure requirement in California; working with the Federal Trade Commission to achieve the first national franchise disclosure rule in 1979; continuing with our efforts that contributed to changes to the federal Franchise Rule in 2007; and ensuring an ongoing constructive dialogue between our leadership and federal and state regulators and government leaders, the IFA has continually worked for improvements to pre-investment franchise disclosure and franchise relations.

Through the considerable and continuing efforts of our association and its members, the IFA has contributed to the growth and stability of franchising in the United States. It is because of the historic and continuing efforts of the IFA and its members to improve pre-investment disclosure and advance beneficial franchising practices that franchising is one of the most important vehicles today for the creation of small businesses ownership and jobs in the United States.

This Statement of Guiding Principles has been promulgated for and has been adopted by the Board of Directors of the International Franchise Association in our continuing effort to advance improvements in franchise practices and to enhance franchise relations. As an association of franchisors, franchisees and suppliers we believe:

1. Franchising is a unique business model. It is in the interest of the franchisor, each franchisee, the suppliers to the franchise system and the consuming public that franchisors define, maintain and enforce Brand Standards throughout the franchise system.

2. It is the goal of every business that each stakeholder be successful and franchising is no different. Franchisors and franchisees need to be profitable to be successful. However, as in any business model, franchising is not immune to the risk of failure and neither the franchisor nor the franchisee is guaranteed economic success.

3. Franchisees should clearly understand the franchise business model before investing. It is the responsibility of each prospective franchisee to conduct a thorough due diligence of the franchise system, to retain competent legal and other advisors, and to fully understand the terms contained in the Franchise Disclosure Document before signing any Franchise Agreement.

4. Prospective franchisees have the prerogative, at the start of the franchise relationship, whether or not to enter into any particular franchise relationship. Prospective franchisees may also choose to not become franchisees of any franchise system.

5. While not transferring any equity in the franchisor's intellectual property to the franchisee, franchisees should have the opportunity to monetize any equity they may have developed in their business prior to the expiration or termination of the franchise agreement.

Continued>>

INTERNATIONAL FRANCHISE ASSOCIATION

STATEMENT OF GUIDING PRINCIPLES

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6 The licensor is the owner of its intellectual property, including without limit, its trademarks, trade secrets, methods and standards of operations. The Licensor has the right and also the obligation, under the law, to protect its intellectual property and to define the terms under which it licenses to others the use of its intellectual property. It is the terms contained in the Franchise Agreement that define the license granted to franchisees and which govern the relationship between the franchisor and franchisee.

7 Franchisors should clearly understand the franchise business model prior to choosing franchising as a method to expand their business concept. Franchisors should be knowledgeable and understand the financial, business and legal terms included in their Franchise Disclosure Document and Franchise Agreement.

8 The franchisor has the right, as owner of its intellectual property, to include or not include successor rights in the Franchise Agreement offered to prospective franchisees. The franchisor also has the right to establish the then current terms contained in the successor agreements it offers to franchisees. Franchisees may choose to negotiate, accept or reject any offer.

9 Clarity and transparency is essential for establishing and maintaining positive franchise relationships and for the goal of continuous improvements in the franchising environment. Franchisors and franchisees should maintain proactive business policies, communication practices and regularly consult with each other for the enhancement of franchise relations.

10 Subject to the requirements under the law, franchisors should focus primarily on the business requirements of managing and striving for improvements to their franchise system. Franchisors should support their franchisees and enforce Brand Standards necessary to enhance the economic performance for both the franchisees and the franchisor. It is the responsibility of franchisees to manage the day-to-day affairs of their businesses to meet the franchisor's Brand Standards.

11 Improved pre-investment disclosure will benefit both prospective franchisees and franchisors by enhancing the competition among franchisors for qualified franchisee candidates. By clearly communicating the terms contained in a franchise offering, prospective franchisees will be better able to evaluate and make investment choices among the wide range of franchise opportunities available to them and to choose from those that meet their goals, ambitions, financial and, other requirements.

12 Market Forces, and not government mandates and relationship laws, should create the climate for changes to Franchise Agreements and should drive improvements in franchising practices.

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