Is It Time to Rebuild the U.S. Franchise Regulatory System?

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If you took a snapshot of all the laws and regulations governing franchising in the United States in 1979, and then took another snapshot of all the laws and regulations governing franchising today, you would find them very similar. While the rest of the world, including franchising, has been dynamic and constantly changing, franchise regulation has been, essentially, static.

A quick history lesson: Most state franchise sales and disclosure laws and franchise relationship laws were enacted in the first half of the 1970s. The Federal Trade Commission's Franchise Disclosure Rule went into effect in 1979. Since then, there has been one successful effort to modify the FTC Disclosure Rule, in 2007; a few amendments to existing state disclosure and relationship laws; and new laws adopted in a couple of jurisdictions, namely New York, Iowa, Delaware and Rhode Island. A couple of states have also eliminated or modified their filing requirements under their state disclosure and sales laws. But, overall, a Rip Van Winkle franchise attorney, having been asleep for some 35 years, could wake up today and, for the most part, continue where he had left off. Moreover, he would discover, after only doing a little bit of due diligence, that the courts had rendered only a few life-changing decisions during this period.

Is this stability good or bad for the franchise sector?

Those favoring stability in regulation might argue that the absence of change has been good for franchising. A static environment is not, by its nature, bad. However, this assumes that the existing regulatory scheme is effective. Many of us, however, feel that it is just the opposite—the regulatory scheme has been very ineffective: The sales and disclosure process is antiquated and too costly; the registration process adds little to the effectiveness of franchise sales regulation but cost; and the franchise relationship laws more often than not create miscarriages of justice, rather than effective prevention of franchisor abuse, except in the most extreme circumstances.

On March 30, 2012, the Franchise Law Institute, which the author founded in 2011, sponsored a colloquium to discuss several issues relating to the U.S. franchise regulatory system. Attendance at the program was by invitation only, and attendees represented 20 of the most knowledgeable franchise lawyers, franchisee lawyers, and lawyers who worked on both sides, as well as two respected franchise consultants, one academic and one state regulator. The results of the program were both instructive and, to some of those present, astonishing.

Regulation and Preemption

First, there was almost a complete consensus that the entire area of franchise regulation should be preempted by the federal government. Support for this proposition from the franchisor lawyer constituents was not unexpected. Most of this group views franchise sales disclosure and registration as an albatross. It is costly, and it is questionable how much fraud it has eliminated.

There probably is little doubt that franchise sales disclosure, and possibly registration, has reduced fraud in the franchise sales process. However, it has come with a cost, one that is not insignificant, especially to the larger franchisors. Most believe that franchise registration has had a salient effect on the franchise marketplace, but there has been, to this author's knowledge, no convincing proof that there has been less fraud and better buying decisions by prospective franchisees in Wisconsin, for example—a registration state—than in a non-registration state such as Tennessee.

The surprise on this issue came from the franchisee lawyer constituency. The sales and disclosure laws governing franchising as well as the so-called relationship laws were designed to protect against fraud and bullying by franchisors. However, the franchisee lawyer's viewpoint is perfectly understandable. The complexity of having to deal with both federal and state, and often multistate, regulation has added cost franchisees must incur in order to litigate. It is easy to plead the laws of multiple states to protect and enforce one's rights, but having to review the laws of potentially numerous jurisdictions, understand the laws of all these jurisdictions, and then to prove the necessary elements to win one's case can be burdensome and taxing on a franchisee's already nearly empty coffers.

Private Right of Action

The second point of significance that came out of the colloquium was that both franchisor and franchisee lawyers favored the creation of a private right of action under the FTC Franchise Rule for franchisees. The FTC tried to give franchisees such a right when the FTC Franchise Rule was adopted, but the federal courts were of a different mind. Shortly after the FTC Franchise Rule went into effect, a federal court, in New York, ruled that there was no private right of action under the FTC Franchise Rule.[1]

Again, the franchisor and franchisee legal representatives were of the same mind, that a private right of action was not a bad thing, but here it was the support of the franchisor lawyers that was unexpected. Why? Perhaps it was the result of a silent tradeoff that franchisors would be willing to support in order to achieve political support for preemption. But that thought was not clearly articulated at the colloquium. Was this position taken by franchisor lawyers strategic, or was there an honest belief that the private right of action was warranted, regardless of one's adversarial position?

Registration

The third point discussed at the colloquium on which there was agreement, although not necessarily a general consensus, was that the registration process should be moved to the federal level—exclusively. Some thought that registration was altogether unnecessary, but for the most part, the attendees did not think that registration was a bad idea; their complaint was having to register and go through the review process multiple times in the different registration states added little to improving franchise disclosure and, was time-delaying and costly.

Is this the case? As to having a review process, the state administrator present at the colloquium commented that many of the disclosure documents his office receives are poorly drafted and incomplete, and the review process either corrects these problems or encourages franchisors to abandon the idea of franchising. Conceptually, this rationale is appealing, but it should be noted that registration and review have become somewhat of a barrier to entrance into the franchise marketplace. Is that what regulation is intended to do? Or should regulation encourage competition, but only when the competition is not harmful to the community of would-be franchisors?

Disclosure Document

And finally, the attendees focused on the Franchise Disclosure Document—the document given to prospective franchisees and which is intended to disclose to them many material aspects of the franchise they are considering purchasing. In 2007, and in the eight to 10 preceding years, a significant amount of time and effort was committed to scrutinizing the disclosures being made to prospective franchisees. In 2007, the old forms of disclosure documents were abandoned in favor of a new disclosure format—now called the Franchise Disclosure Document, or FDD. Millions of dollars and a significant amount of time were spent arguing for various changes to the form of disclosure document, but in the end were the changes that dramatic?

The majority viewpoint of the colloquium attendees, I perceived, is that the changes were generally marginal in light of the time and money spent scrutinizing the old Uniform Franchise Offering Circular. Admittedly, there were a few changes that improved the quality of disclosure, such as the amendments to the Item 20 charts, some of the changes involving disclosure of litigation brought by franchisors, and the addition of information about franchisee associations, to name only a few. However, the more significant changes related to the technical issues surrounding disclosure, in particular the adoption of electronic disclosure and the timing of disclosure.

Notably, the elimination of the requirement that a prospect must be given an FDD before it meets with the franchisor eliminated the concern as to what constituted a "first personal meeting." Keeping the rule that a prospective franchisee may not sign a franchise agreement until he has had the FDD for at least 14 days, and that a franchisee could not pay anything to the franchisor until at least 14 days after the disclosure document had been given to the prospective franchisee were, in the FTC's eyes, sufficient to prevent hotboxing—that is, where the franchise salesperson puts extreme pressure on the prospective franchisee to buy the franchise at that very moment or else lose the opportunity. Unfortunately, the first personal meeting rule still exists under state law in a few jurisdictions.

There was also widespread concern that the FDD was more of a legal document than one focused on the business aspects of the franchise. Many of the disclosures in an FDD are only marginally informative. As an example, read what franchisors might say about the marketplace in Item 1 of their FDDs. One typical document the author recently read, stated:

The sales and lease ownership market is highly competitive and the Franchise will compete with a number of businesses providing similar products and services, including at least one franchise program similar to the Franchisor's. The Franchise also will compete with regional and national firms engaged in the sale and lease ownership industry. In addition, you will compete with other retail stores.

Does a prospect really learn anything important about the marketplace by this general, nebulous, statement about competitors?

On the whole, most of the participants at the colloquium felt that the FDD educated a prospective franchisee on his legal rights, but left it to the prospect to find meaningful information about what a franchise relationship entailed from a business perspective.

Possible Reasons

So, given all these significant flaws in the franchise regulatory scheme, why hasn't there been an overwhelming call for change, similar to the one that de facto came out of the colloquium. Since then, there has been no other call for or movement toward reform, with one exception—in 2013 at the American Bar Association's Forum on Franchising's Annual Program held in Orlando, Fla. Since then, there has been no other call for or movement toward reform. Why?

One reason is the traditional devil known is better than the unknown devil, and, to use another cliché, once the genie is let out of the bottle, there is no way to put her back in. Second, for the diabolical persons among us, they might prefer the current scheme which, one might argue, creates a barrier to entry into the franchise playing field.

Third, the concept of preemption might be anathema to the states' rights advocates among us, who believe that franchise regulation is best left to the states to decide how it should be structured and implemented. Fourth, there are certain stakeholders in the franchise regulatory scheme that have vested interests in maintaining the status quo. The state regulators may feel that their laws are more protective of the prospective franchisee community, and in this respect, they are right. And finally, the federal government's historical failure to provide adequate financing for federal enforcement also comes into play here.

But perhaps the most poignant reason why a movement toward preemption has not developed is that no stakeholder has stepped up to the bar and become a leader in such a movement, and until that occurs, it is highly probable that the franchise community will stay comfortably settled in under the current regulatory scheme.

Notwithstanding the high cost of the current system and its inefficiencies, radical change lies far beyond the horizon for the moment.

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