

FRANCHISE REGULATION: AN APPRAISAL OF RECENT STATE LEGISLATION†

The franchise boom of the past decade has evidenced unprecedented growth in the franchise industry. In those years the number of franchised outlets doubled, from three hundred thousand¹ to nearly six hundred thousand units.² Current annual sales through franchised outlets are approximately ninety billion dollars and represent nearly ten percent of the country's Gross National Product.³ Although there was some movement during the sixties toward regulation of this significant sector of the economy,⁴ legislative action was frustrated by conflicting and sometimes passionate argumentation⁵ supported by inaccurate and misleading statistics.⁶ In addition, until recently franchisor associations had seen no need for "remedial legislation" for even the "acknowledged imperfections" in franchising,⁷ and currently they remain unwilling to accept more than partial legislation.⁸ Subject to con-

† This comment was introduced into the public record at the Federal Trade Commission Hearings on Proposed Trade Regulation Rule Involving Disclosure Requirements and Prohibitions Concerning Franchising, FTC Doc. No. 215-34 (Feb. 14, 1972). The proposed rule is found at 36 Fed. Reg. 21607, 22187 (1971).

¹ Bond, *Franchise Statistics: Their Uses and Abuses*, in *Franchising Today* 1969 at 45 (C. Vaughn ed. 1969) (based on data included in the statement of the International Franchise Association [hereinafter IFA] Before the Subcomm. of the House Select Comm. on Small Business, Nov., 1963).

² Vaughn, *Growth and Future of Franchising*, in *Franchising Today* 1969 at 269 (C. Vaughn ed. 1969).

³ Hearings on *The Impact of Franchising on Small Business*, Before the Subcomm. on Urban and Rural Economic Development of the Senate Select Comm. on Small Business, 91st Cong., 2d Sess. pt. 1, at 1 (1970) [hereinafter cited as 1970 Hearings].

⁴ At the federal level Senator Hart's bill regulating franchise terminations was first introduced as H.R. 10113, 89th Cong., 1st Sess. (1965). It was redrafted and introduced as S. 2321, 90th Cong., 1st Sess. (1967), and again as S. 1967, 91st Cong., 1st Sess. (1969). The bill was recently reintroduced, on August 6, 1971, as S. 2472, 92d Cong., 1st Sess. (1971). For state bills regulating franchising introduced in the sixties see Rudnick, *State Legislation Affecting Franchising*, in *IFA Legal Bulletin* 1969 II at 36 (L. Rudnick ed. 1969).

⁵ See, e.g., statements of Harold Brown, J.F. Atkinson, Robert Dias, Philip Zeidman and the Hon. Louis J. Lefkowitz, 1970 Hearings, *supra* note 3, at 2, 49, 111, 140, and 522, respectively. Compare H. Brown, *Franchising: Trap for the Trusting* (1969) with J. Atkinson, *Franchising: The Odds-On Favorite* (1968). For an objective analysis see Report of Ad Hoc Committee on Franchising, in 2 *The Franchising Sourcebook*, app. A, 561 (J. McCord ed. 1970).

⁶ See Senate Select Comm. on Small Business, 92d Cong., 1st Sess., *The Economic Effects of Franchising* 66 (Comm. Print 1971) [hereinafter cited as *Economic Effects of Franchising*]. The study recommends that the IFA withdraw from circulation all copies of the book *Franchising: The Odds-On Favorite* by J.F. Atkinson, because "[t]he book presents grossly inaccurate data on failure rates and would be very misleading to potential franchisees." *Id.*

⁷ Statement of Philip Zeidman, Washington Counsel, IFA, 1970 Hearings, *supra* note 3, at 140, 143.

⁸ IFA Position Paper, "Views of the International Franchise Association Relative to State Franchise Legislation," at 3 (1971) (on file in office of B.C. Ind. & Com. L. Rev.); Brown, *Franchising: Legislating Full Disclosure, Good Faith and Fair Dealing*, 15 *Boston B.J.* No. 8 at 15, 19 (1971).

stant lobbying pressure from these associations, many states have remained unable to enact much-needed legislation.⁹

The recent economic recession brought ruin to many franchisors and their franchisees.¹⁰ This financial disaster exposed to public scrutiny the abuses to which franchisees are subject from the time the franchise relationship begins until long after it ends.¹¹ As a result of the increased public awareness of such abuses, the seventies are witnessing widespread franchising legislation.¹² This comment will survey the approaches taken by the various states in their attempts to deal with franchise abuses. First, the abuses will be summarized so that the purpose of franchise legislation may be placed in perspective. The failings of the traditional remedies to cope with these abuses will then be examined in order to indicate the urgent need for franchise legislation. State regulations, both enacted and proposed, will be discussed and compared.¹³ The comment will focus upon exemplary statutes for the purpose of in depth analysis; reference will be made to similar legislation of other states. Finally, proposed federal measures will be compared with the state approaches to the problems of franchising.

I. FRANCHISE ABUSES

Franchise abuses are not merely "imperfections" in an otherwise equitable system. Such abuses, both actual and potential, are extensive and pervade the entire relationship. When a prospective franchisee expresses an initial interest in purchasing a franchise, he is usually bombarded with offering literature that is "either inadequate, misleading, wholly lacking or blatantly false as to material facts necessary to making an intelligent investment decision."¹⁴ The advertisement creat-

⁹ See Report of Lewis G. Rudnick, 4th Annual Franchising and Government Symposium of the IFA, May 17, 18 and 19, 1971 (Report on file in office of B.C. Ind. & Com. L. Rev.). An example of the success of the IFA's lobbying efforts is the amendment to the Washington Franchise Investment Protection Act which delays the effective date of the Act for one year, ostensibly to "afford the IFA an opportunity to propose and advocate a substitute law." *Id.* at 11.

¹⁰ Elliott, No Burned Fingers, *Barron's*, April 12, 1971, at 3, col. 1; Paulson, Franchises Shaken by Hard Times, *The National Observer*, July 8, 1971, at 8, col. 1.

¹¹ *Id.*; Moneysworth, Aug. 9, 1971, at 1, col. 1; Noble, One Man vs. An Industry, *Newsday*, Sept. 8, 1971, at 72A, col. 1.

¹² Cray, Legislatures Acting on Franchising, *N.Y. Times*, July 18, 1971, § 3 (Business), at 13, col. 1; Wong, In Absence of Federal Rules, More States Begin Regulating the Franchising Industry, *Wall Street Journal*, Oct. 11, 1971, at 22, col. 1.

¹³ This article will not deal with state legislation which is limited to specific types of franchises. In fact, the single-industry approach appears misguided. "It is inadequate if all industries are not covered, and it is unnecessary to cover each industry separately." Canadian Dept. of Financial & Commercial Affairs, Report of the Minister's Committee on Franchising, at 52-53 (1971). The best example of the single-industry approach is the legislation passed in response to extensive automobile dealer lobbying which is designed to protect the automobile dealer only. See, e.g., Mass. Gen. Laws Ann., ch. 93B (1971). For an excellent analysis of the Massachusetts law and a compilation of other state automobile franchising legislation, see Brown, A Bill of Rights for Auto Dealers, 12 B.C. Ind. & Com. L. Rev. 757, 758 n.5 (1971).

¹⁴ Statement of the Hon. Louis J. Lefkowitz, Attorney General of the State of New

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ing the prospective franchisee's initial interest may have been filled with misleading information¹⁵ despite the claim of many publishers that they screen such ads.¹⁶ Potential profits¹⁷ and potential volume of sales¹⁸ are usually overstated to an alarming degree. A recent study of franchise abuses in New York State revealed that the franchisee may purchase a franchise from a company involved in a bankruptcy reorganization without any notice of the financial condition of the franchisor.¹⁹ The study also revealed that the franchisee may find himself owning a franchise in a company controlled or dominated by ex-convicts or persons presently under indictment.²⁰ In either case the franchisee may lose an investment representing his life savings.²¹

Once the franchise agreement has been signed, the franchisee becomes subject to an entirely new set of abuses. Promised assistance and equipment may not be immediately available, and may never become available due to insufficient capitalization by the franchisor.²² The franchisor may even fail to deliver the franchised business itself within a reasonable time after consummation of the sale.²³ Furthermore, as a result of the franchisee's relatively weak bargaining position, the franchise agreement often contains inequitable provisions²⁴ such as "tying arrangements" (clauses requiring franchisees to buy unwanted equipment or supplies "tied" to necessary items). These arrangements are used in the franchise agreement to force the franchisee to buy all supplies exclusively from the franchisor, sometimes at two or three times the fair market price.²⁵ Fortunately for the franchisee, such clauses are now generally regarded as *per se* violative of the antitrust laws.²⁶ The franchisor is now permitted to require exclusive purchasing

York, 1970 Hearings, *supra* note 3, at 522, 523 [hereinafter cited as Lefkowitz, 1970 Hearings].

¹⁵ National Dynamics Corp., 3 Trade Reg. Rep. ¶ 19,653 at 21,710 (initial decision to cease and desist, May 24, 1971); International Sales Co., 3 Trade Reg. Rep. ¶ 19,663 at 21,715 (consent order to cease and desist, June 22, 1971).

¹⁶ Statement of Julius Schmitt, Classified Advertising Manager, N.Y. Times, 1970 Hearings, *supra* note 3, at 506. "[W]e require . . . bank and . . . business references . . . [and] a copy of the franchise contract . . ." *Id.* at 507. Statement of Joseph Perrone, National Classified Advertising Manager, Dow Jones & Co., *id.* at 572-73. But see statement of David Shulman, Editor & Publisher, Franchise Journal, *id.* at 574.

¹⁷ "72.5% of the franchisees earned less than the 'minimum expected,' 91.8% earned less than the 'average expected.' . . ." Economic Effects of Franchising, *supra* note 6, at 143.

¹⁸ "69.6% of franchisees in 1969 failed to reach the 'minimum expected sales volume' [and] 86.9% failed to reach the 'average sales volume.' . . ." *Id.* at 145-46. See Barton's Candy Corp., 3 Trade Reg. Rep. ¶ 19,554 at 21,624 (consent order to cease and desist, Mar. 18, 1971).

¹⁹ Lefkowitz, 1970 Hearings, *supra* note 14, at 524.

²⁰ *Id.*

²¹ *Id.* at 531.

²² Statement of Robert Dias, Pres., Nat'l Ass'n of Franchise Businessmen, 1970 Hearings, *supra* note 3, at 117, 124 [hereinafter cited as Dias, 1970 Hearings].

²³ Augustine & Hrusoff, Franchise Regulation, 21 Hast. L.J. 1347, 1373-74 (1970).

²⁴ Economic Effects of Franchising, *supra* note 6, 261-62.

²⁵ Brown, *supra* note 5, at 16.

²⁶ Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971).

only when quality or secret processes cannot be adequately protected by specification of purchasing requirements.²⁷ However, under the guise of "quality control," operating franchisees are still often required to purchase either from approved suppliers or from the franchisor himself. Besides possessing inherent anticompetitive effects, buying from approved suppliers often presents the problem of kickbacks from the supplier to the franchisor.²⁸ In fact, over forty percent of the franchisees canvassed in a study sponsored by the Small Business Administration²⁹ either knew or suspected that their franchisors were taking kickbacks.³⁰ The study concluded that such widespread belief "cannot be entirely dismissed as misperception."³¹

Of all the abuses to which a franchisee may be subject, those occurring in the context of renewal or termination of the franchise agreement are perhaps the most sensitive.³² The problem is pervasive: termination clauses appear in one hundred percent of all fast food franchise agreements.³³ From the franchisor's viewpoint, actual termination of a franchise as a means of coercing franchisees to comply with the desires of the franchisor is often undesirable. However, a threat of termination may effectively accomplish the franchisor's goal without entailing the drawbacks of actual termination. Although some disagreement exists as to the extent to which termination threats are used, there is little disagreement that the fear of actual termination has a substantial effect on franchisees.³⁴ The franchisor plays on this fear to compel the franchisee "to adhere to practices which may be detrimental to his business—such as directed purchases, handling only products of the franchisor, retail price maintenance, not selling to selected customers, unprofitable mandatory working hour requirements, etc."³⁵

In addition, provisions in the franchise agreement which appear reasonable on their face may be discriminatorily enforced with respect to an individual franchisee, and thereby used to terminate either recalcitrant or extremely profitable franchises, in the latter case so that the

²⁷ *Id.* at 51. *Accord*, *Standard Oil Co. v. United States*, 337 U.S. 293, 306 (1949).

²⁸ *Brown*, *supra* note 5, at 16.

²⁹ See note 6 *supra*.

³⁰ *Economic Effects of Franchising*, *supra* note 6, at 162.

³¹ *Id.* at 163.

³² *Id.* at 269.

³³ *Id.* at 274.

³⁴ *Brown*, *supra* note 5, at 22: "[T]he franchisee must live in constant peril of termination of his franchise and loss of his investment." See also *Economic Effects of Franchising*, *supra* note 6, at 276. This study found that while only 12.9% of the franchisees interviewed had ever been directly threatened with termination by their franchisors, nevertheless "franchisees may feel an implied threat of termination because of the way most franchise agreements dwell on the franchisor's right to terminate." *Id.*

³⁵ *Dias*, 1970 Hearings, *supra* note 22, at 125. See *Shanahan*, *Illegal Franchise Actions Laid to Chock Full o'Nuts*, *N.Y. Times*, Nov. 12, 1971, at 71, col. 7. The Federal Trade Commission has accused Chock Full o'Nuts Corp. of enforcing its illegal pricing policies by informing its licensees "that their franchise agreements would be terminated if the items were sold at other than the specified prices." *Id.*

franchisor may take over the franchise himself.³⁶ Requirements which may be discriminatorily applied include those to keep franchise premises open for business twelve hours a day, 365 days per year; to keep sidewalks and parking area free and clear of snow, ice and rubbish; to use only equipment and fixtures approved by the franchisor; to wear uniforms specified by the franchisor; to present a neat and clean appearance; and to render competent and courteous service.³⁷ As a result, more than seventy-five percent of the fast food franchisees interviewed in the previously referred to Small Business Administration study³⁸ felt that federal legislation was needed which would permit termination of a franchise *only* if the franchisee failed to "substantially comply" with the provisions of the franchise contract.³⁹ Finally, following termination, and regardless of its reason, the franchisee may be subject to a far-reaching covenant not to compete,⁴⁰ generally upheld by the courts if not "unreasonable."⁴¹ The covenant usually provides that the franchisee will not engage in a competing business within a designated locale for a prescribed period.⁴² Because direct remediation of franchise abuses has only recently been attempted through state legislation, franchisees in the past sought to protect themselves from abuses by means of traditional common law remedies.

II. THE TRADITIONAL REMEDIES

Although it has been suggested that the franchise agreement be considered as establishing a fiduciary relationship between franchisor and franchisee,⁴³ or that certain portions of the Uniform Commercial Code could be used to reach franchise abuses,⁴⁴ historically most aggrieved franchisees have relied upon common law fraud actions or suits instituted under antitrust laws in order to obtain relief. It is the failure of these remedies which has created the need for franchise legislation.

The action for fraud has generally been applied in the context of abuses in the sale of a franchise.⁴⁵ The number of fraud complaints has

³⁶ Dias, 1970 Hearings, *supra* note 22, at 121; Economic Effects of Franchising, *supra* note 6, at 275. Cf. Oxenfeldt & Kelly, Will Successful Franchise Systems Ultimately Become Wholly-Owned Chains?, 44 J. Retailing No. 4, 69, 70-72 (1969).

³⁷ Economic Effects of Franchising, *supra* note 6, at 275.

³⁸ See note 6 *supra*.

³⁹ Economic Effects of Franchising, *supra* note 6, at 277.

⁴⁰ Brown, *supra* note 5, at 27.

⁴¹ Restatement of Contracts, § 516(f) (1932).

⁴² Brown, *supra* note 5, at 27.

⁴³ Brown, Franchising—A Fiduciary Relationship, 49 Texas L. Rev. 650 (1971); *Jirna Ltd. v. Mister Donut of Canada, Ltd.*, [1971] 13 D.L.R.3d 645 (1970), rev'd, 1 Karas Exec. Rep. No. 14, at 1 (Oct. 11, 1971). The lower court found that "the close association of the franchisor and the franchisee in this case has created what must be construed as a fiduciary relationship. . . ." [1971] 13 D.L.R.3d at 654.

⁴⁴ Comment, Article Two of the Uniform Commercial Code and Franchise Distribution Agreements, 1969 Duke L.J. 959 (1969).

⁴⁵ H. Brown, The Realities of Franchising, in 2 The Franchising Sourcebook 191, at 199 (J. McCord ed. 1970). For an example of a fraud complaint see An Illustrative Complaint, in The Realities of Franchising, A Guide for the Practicing Attorney 99 (1970).

increased in recent years due to widespread use of misrepresentations of fact and deceptive advertising in the sale of franchises.⁴⁶ Such misrepresentations are employed in order to sell as many franchise units as possible since "many franchisors receive a substantial portion of their gross income from the sale of franchises. . . . Consequently, there is an incentive to tell the prospective franchisee almost anything to make the sale."⁴⁷ If the requirements of fraud can be proved,⁴⁸ the court may award damages or grant rescission of the franchise contract. In addition to reliance damages, the franchisee may recover excessive franchise fees and royalties, and overpayments made due to restrictive purchasing agreements. Rescission, on the other hand, would attempt to restore the parties to their precontract positions insofar as is reasonably possible.⁴⁹

Despite these remedies the effectiveness of actions for fraud in controlling franchise abuses has been limited by several factors. First, many franchisees fail to file complaints;⁵⁰ even if complaints are filed, the remedies are often unsatisfactory since the fraud action is an "after the fact" remedy.⁵¹ The franchisee has already paid out the franchise fee and has often incurred substantial losses in running the business.⁵² Thus, in many instances, the franchisee is insolvent and cannot afford to retain counsel to pursue a civil action.⁵³ Even if successful, victory often comes after protracted litigation and may be fruitless; the franchisor is often bankrupt and thus judgment-proof.⁵⁴

Actions have been brought against franchisors for violations of the antitrust laws.⁵⁵ These cases have dealt largely with the abuses

⁴⁶ Statement of Clark Bradley, California State Senator, 1970 Hearings, *supra* note 3, at 595-96 [hereinafter cited as Bradley, 1970 Hearings]. It previously was disclosed at the California Franchise Hearings that with respect to criminal complaints the franchise fraud area has risen from a "comparatively minor place to No. 1 in terms of formal investigations and work load in the business fraud division . . ." *Id.* at 596.

⁴⁷ Augustine & Hrusoff, *supra* note 23, at 1370-71.

⁴⁸ The common law action of deceit consisted of five elements: a false representation by the defendant, ordinarily a misrepresentation of fact; knowledge or belief on the part of the defendant that the representation was false; an intention to induce the plaintiff to act or refrain from action in reliance upon the misrepresentation; justifiable reliance upon the representation on the part of the plaintiff; damage to the plaintiff resulting from such reliance. W. Prosser, *Law of Torts* 685-86 (4th ed. 1971).

⁴⁹ Brown, *supra* note 5, at 35.

⁵⁰ The reasons usually given for this failure are:

- (1) the typical victim is embarrassed over being swindled and is thus reluctant to file a complaint;
- (2) he believes that he cannot help his own cause by filing a complaint;
- (3) he hopes to salvage his investment and spends more time and money doing so, invariably resulting in further losses; and
- (4) he feels that it is too late for recourse, because of the time span between the payment of the franchise fee and the discovery of the fraud.

Bradley, 1970 Hearings, *supra* note 46, at 597.

⁵¹ Augustine & Hrusoff, *supra* note 23, at 1373.

⁵² *Id.*

⁵³ See Bradley, 1970 Hearings, *supra* note 46, at 597.

⁵⁴ Augustine & Hrusoff, *supra* note 23, at 1373.

⁵⁵ The ramifications of the antitrust laws on franchising have been extensively dis-

which occur during the existence of the franchise relationship, with courts inquiring into the reasonableness of the controls and restrictions imposed by the franchise agreements.⁵⁶ Despite the demonstrated antitrust illegality of many franchisor practices,⁵⁷ franchisors have been unwilling to cease such practices. At the core of this recalcitrance may be a realization by franchisors that the antitrust laws are relatively ineffective at reaching franchising abuses and hence pose little threat of financial loss. It is known, for example, that few franchisees can afford to maintain an antitrust suit; and the threatened loss of even treble damages in the isolated instances which result in litigation often fails to outweigh the potential profits to be gained from the illegal practice.⁵⁸

Despite the salutary effect of *Siegel v. Chicken Delight, Inc.*,⁵⁹ the antitrust laws generally remain ineffective as remedies for franchise abuses. The antitrust remedy suffers weaknesses similar to those of the fraud action. It is also an "after the fact" remedy and, as in fraud actions, the franchisee may be insolvent and unable to afford the expense of litigation.⁶⁰ This is especially true since the complex antitrust action usually involves substantial pretrial discovery and large expenditures of time by the attorney involved.⁶¹ The cost, viewed in light of the possibility of losing the suit, may deter even solvent franchisees from maintaining such actions. To some extent, however, this risk has been alleviated by the recent liberalization of class actions under the Federal Rules of Civil Procedure.⁶²

cussed; see D. Thompson, *Franchise Operations and Antitrust* (1971); J. Curtin, P. Donovan, & J. Hally, *Application of Antitrust and Trade Regulation Statutes, in The Realities of Franchising, A Guide for the Practicing Attorney* 27 (1970); Pollock, *Antitrust Problems in Franchising*, 15 N.Y. L.F. 106 (1969); Covey, *Franchising and the Antitrust Laws: Panacea or Problem?*, 42 Notre Dame Law. 605 (1967); Zeidman, *Antitrust Aspects of Franchising*, 45 Michigan State B. J. No. 5, at 27 (1966).

⁵⁶ See *Perma Life Mufflers, Inc. v. International Parts*, 392 U.S. 134 (1968); *Albrecht v. Herald Co.*, 390 U.S. 145 (1968); *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967); *United States v. Sealy, Inc.*, 388 U.S. 350 (1967); *FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971); *Susser v. Carvel Corp.*, 332 F.2d 505 (2d Cir.), cert. granted, 379 U.S. 885 (1964), cert. dismissed as improvidently granted, 381 U.S. 125 (1965).

⁵⁷ *Albrecht v. Herald Co.* 390 U.S. 145 (1968) (combination to fix maximum prices); *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967) (vertical territorial restrictions); *United States v. Sealy, Inc.*, 388 U.S. 350 (1967) (horizontal territorial restrictions); *F.T.C. v. Brown Shoe Co.*, 384 U.S. 316 (1966) (exclusive dealing provisions); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971) (tying arrangement).

⁵⁸ *Augustine & Hrusoff*, supra note 23, at 1353.

⁵⁹ 448 F.2d 43 (9th Cir. 1971). Here an antitrust class action by franchisees against their franchisor was successful in proving a tying arrangement in violation of the Sherman Act. But even here the franchisees may have won only a nominal victory; the case was remanded by the Circuit Court of Appeals for a limited trial as to whether damage had resulted (a complicated issue because *Chicken Delight* did not collect royalties or franchise fees but received 100% of its income from the sale of supplies and equipment).

⁶⁰ Curtin, Donovan, & Hally, supra note 55, at 51: "Antitrust cases . . . are among the most expensive litigation processes known." *Id.*

⁶¹ *Id.*

⁶² Fed. R. Civ. P. 23.

The class action was successfully utilized in the *Chicken Delight* case by five plaintiffs who brought an antitrust suit on behalf of six hundred and fifty franchisees.⁶³ However, the defeated franchisor, faced with an enormous treble damage judgment, will probably be forced into bankruptcy, leaving his franchisees stranded. Although in some franchises a franchisee can continue to operate without a franchisor, a situation in which the franchisee's profit margin would be increased since he would no longer be making royalty payments to a franchisor, there are far more franchises in which the interests of the franchisor and franchisee are so interrelated that, should the franchisor become bankrupt, the franchisee would follow.⁶⁴ Even in those cases in which the franchisee could continue to operate, he would be faced with many new problems, the most difficult being that he could no longer use the franchisor's trademark. Instead, the franchisee would have to operate under a new name, one less well known to the public. Thus franchisees who employ an antitrust class action must be prepared not only for protracted litigation but also, in the event of success, for the probability that the franchise system will be destroyed, leaving the franchisees to fend for themselves.⁶⁵

A final reason for the remedial ineffectiveness of the antitrust laws in franchising abuses is that the antitrust laws do not even *reach* many franchising abuses. The antitrust laws do not apply to franchisor misrepresentations, to the sale of a franchise by a bankrupt franchise company or one run by criminals, or to restrictions dealing with transfer, renewal or termination of the franchise. Because of these limitations, the federal antitrust laws have been inadequate to combat franchise abuses.

Recently the franchise investment has begun to be viewed as an investment in a security and therefore subject to regulatory state and federal securities statutes. This development has been at least partially in response to the ineffectiveness of the traditional remedies, and partially due to the belief that the franchise agreement may properly be viewed as a security. On the federal level several cases have raised the question of whether the franchise agreement is a security, but in each case the court failed to decide the issue.⁶⁶ However, in another context,

⁶³ 271 F. Supp. 722, 724-25 (N.D. Cal. 1967).

⁶⁴ Especially in those situations where the franchisee is dependent upon transient customers who rely upon the franchise trademark and in those instances in which a secret process is involved.

⁶⁵ If the trademark, which is simply another asset of the bankrupt franchisor, is unsaleable, there is a possibility that the franchisee could reach an agreement with the franchisor's trustee in bankruptcy wherein the franchisee would give up his claim for treble damages in exchange for the right to use the franchisor's tradename. Most likely, however, the trustee will be able to sell the tradename, in which case the franchisee would have to reach an agreement with the new trademark owner if he wished to continue to use the tradename.

⁶⁶ See *Belhumeur v. Dawson*, 229 F. Supp. 78 (D. Mont. 1964); *Drug Management, Inc. v. Dart Drug Corp.*, C.C.H. Fed. Sec. L. Rep. ¶ 91,293 (D.D.C. 1963). See Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts*,

in *S.E.C. v. W.J. Howey Co.*,⁶⁷ the Supreme Court established guidelines for defining a security: "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."⁶⁸ Since most franchises contemplate operation by the franchisee rather than solely by the franchisor, it is probable that there can be no attempt at federal regulation of the franchise as a security.

On the state level, however, this approach has met with some success. In June, 1967, the Attorney General of California stated in an opinion to the State Commissioner of Corporations that a franchise arrangement may constitute a security within the meaning of the Corporate Securities Law.⁶⁹ He contemplated two situations as subject to regulation. The first exists when the franchisee, in exchange for a share of the profits, contributes capital but otherwise is only "nominally involved" in the management of the business.⁷⁰ This situation would be included within the definition of a security offered by the Supreme Court in *Howey*. Although a question may arise as to when nominal involvement becomes active involvement,⁷¹ the majority of franchises are not subject to regulation on this basis because the franchisee usually takes an active part in the management of the business.⁷²

The second contemplated situation subject to regulation as a security arises when, although the franchisee actively participates in the franchise business, the franchisor intends to utilize the franchise fee substantially to finance the purchase of the goods and services he has agreed to supply the franchisee.⁷³ In this context, the regulation of a franchise as a security relies upon the concept of "risk capital (comprising risky, risked or initial capital) being raised by the franchisor from franchise fees in excess of the reasonable cost of the sale, advertising and promotion (including a fair profit) of franchises, and so really an investment by the franchisee in the franchisor's business. . . ."⁷⁴ Resolution of the issue of whether a franchise may be reg-

Including 10 b-5 Considerations, 24 Bus. Law. 1311 (1969); but see Coleman, A Franchise Agreement: Not a "Security" Under the Securities Act of 1933, 22 Bus. Law. 493 (1967).

⁶⁷ 328 U.S. 293 (1947).

⁶⁸ *Id.* at 301.

⁶⁹ Opinion of Thomas C. Lynch, Attorney General, State of California, 49 Ops. Cal. Att'y Gen. 124 (1967) [hereinafter cited as Opinion of Cal. Att'y Gen.] in Hearings on the Impact of Franchising on Small Business Before the Subcomm. on Urban and Rural Economic Development of the Senate Select Comm. on Small Business, 91st Cong., 2d Sess., pt. 1, app. XI, at 771-78 (1970) [hereinafter cited as 1970 Hearings].

⁷⁰ *Id.* at 773.

⁷¹ Augustine & Hrusoff, *supra* note 23, at 1358.

⁷² Bradley, 1970 Hearings, *supra* note 46, at 595.

⁷³ Opinion of Cal. Att'y Gen., *supra* note 69, at 777.

⁷⁴ Goodwin, *supra* note 66, at 1320. Instead of selling securities to the public to raise capital, thereby becoming subject to the securities laws, the franchisor raises his initial capital from the franchisee. Generally such a franchisor is inadequately capitalized and takes money from one franchisee to fulfill his previously existing obligations to another franchisee, and so on, until the chain stops and the house of cards falls. "At this point the

ulated as a security thus becomes dependent upon the determination of whether the franchisor is adequately capitalized, a difficult question to resolve.

To alleviate difficulties with capitalization, the California Department of Corporations somewhat arbitrarily ruled that if a franchisor has a net worth of over \$500,000 immediately prior to the sale of the franchise he will be considered to be adequately capitalized and the franchise will not be subject to regulation as a security.⁷⁵ However, it is possible for a franchisor to be adequately capitalized with less than \$500,000 and under-capitalized with more than \$500,000.⁷⁶ Furthermore, a franchisor who originally may have been adequately capitalized may subsequently become inadequately capitalized. To keep up with such changes, periodic audits of a franchisor's financial status would be necessary. Due to the number of franchisors and the great expense of such audits, regulation of franchises via security regulations would appear to be merely "a futile gesture."⁷⁷

Additional deficiencies in the securities approach result from the fact that this approach does not deal with such franchise abuses as deceptive advertising, misrepresentation and overly restrictive franchise agreements resulting from inequality of bargaining power. Furthermore, suits under the securities laws are subject to the same criticisms as the traditional remedies: a suit for violation of securities regulations is an "after the fact" remedy involving lengthy litigation, high cost and potentially no more than a pyrrhic victory.

The combination of documented abuses and historically inadequate remedies has made legislation necessary and inevitable. Although a uniform federal law would have been ideal,⁷⁸ such legislation has not been forthcoming. Congressional inaction has resulted in the initiation of state legislative action despite the difficulty most state legislatures have had in determining which legislative approach to take. As a result of the wide range of potential legislative solutions, a wide divergence of regulatory approaches characterizes present state franchising legislation. This comment will now survey the various approaches taken by states enacting such legislation.

III. STATE LEGISLATION

State franchising legislation may be divided into three categories: (a) disclosure legislation, (b) substantive legislation and (c) termination legislation. Disclosure legislation generally requires the franchisor to register the franchise with a state agency and/or direct dis-

franchiser [sic] is left with many obligations he cannot fulfill, to franchisees, suppliers, contractors, and others." Bradley, 1970 Hearings, *supra* note 46, at 596.

⁷⁵ 10 Cal. Admin. Code § 260.105.4 (1969).

⁷⁶ Bradley, 1970 Hearings, *supra* note 46, at 596.

⁷⁷ *Id.*

⁷⁸ See Augustine & Hrusoff, *Franchise Regulation*, 21 *Hast. L.J.* 1347, 1374 (1970); IFA Position Paper, "Views of the International Franchise Association Relative to State Franchise Legislation," at 2 (1971) (on file in office of B.C. Ind. & Com. L. Rev.).

closure of material information to the prospective franchisee prior to his purchase of the franchise. The premise behind this form of legislation is that the disclosed information will enable a prospective franchisee to make an intelligent judgment as to whether he wishes to purchase the franchise. Substantive legislation, on the other hand, attempts to regulate the relationship of the parties during the period of operation under the franchise agreement. Such legislation is based on the belief that, even with adequate information, the unequal bargaining power of the franchisee places him in the position where his interests can be protected only by government regulation of the continuing relationship of the parties. Termination legislation is the result of numerous complaints of unusually widespread abuses in this area. Such legislation generally prohibits termination or refusal to renew without cause. Termination legislation has recently undergone a constitutional attack which may make state regulation in this area impossible.⁷⁹

Before these approaches may be discussed, attention must be given to a problem common to all three forms of franchise legislation: the determination of who should be included within, or excluded from, the scope of the legislation. This determination is generally considered to be the most difficult task in drafting franchise legislation.⁸⁰ The difficulty stems from the fact that franchises cover such a wide range of business operations that a definition drafted to cover all might be overly broad, including operations not really franchises, while a limited definition may not include all those operations desired to be covered.⁸¹ Secondly, considerations of public policy and administrative convenience may act to restrict the scope of the operations sought to be covered by the definition. Two aspects of the resolution of this problem are significant. The legislation may take a definitional approach and set forth a series of requirements by defining the term "franchise" and thus indirectly include or exclude specific types of operations; the legislation may exclude an otherwise included operation by specific exemption from the legislative provisions.

A. *Legislative Scope: Franchise Defined*

The proposed Massachusetts Franchise Fair Dealing Act gives a broad definition of the term "franchise" and serves as an example of the definitional approach:

Franchise shall mean an oral or written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a tradename, service mark, or related characteristics, and in which there is a community of

⁷⁹ See discussion at pp. 558-60 *infra*.

⁸⁰ See Bradley, 1970 Hearings, *supra* note 46, at 598; Canadian Dept. of Financial & Commercial Affairs, Report of the Minister's Committee on Franchising, at 36 (1971) [hereinafter cited as Minister's Committee Report].

⁸¹ Report of Ad Hoc Committee on Franchising, in 2 The Franchising Sourcebook, app. A, 561, 564 (J. McCord ed. 1970); Minister's Committee Report, *supra* note 80, at 36-37.

interest in the marketing of goods or services at wholesale, retail, leasing or otherwise.⁸²

Under this definition the fundamental characteristic of a franchise is the franchisor's permission to the franchisee for use of the franchisor's tradename. The requirement of "a community of interest in the marketing" means merely that both the franchisor and franchisee have a common interest in the marketing of the goods or services: "each . . . derive[s] a material benefit and sustain[s] a mutual responsibility."⁸³

The interesting aspect of the "community of interest" requirement is that this language could be found to create fiduciary duties in the franchise relationship, a result which no American court as yet has considered.⁸⁴ Historically, the term "community of interest" has been used in connection with common ownership of securities and other property.⁸⁵ In these cases the courts have stated that a "[c]ommunity of interest involves mutual obligation,"⁸⁶ and "creates such a relation of trust and confidence that it is inequitable to permit one of the parties in interest to do anything to the prejudice of others . . ."⁸⁷ By analogy, a court interpreting the Massachusetts definition could find that the legislature intended to create a fiduciary relationship between the franchisor and franchisee "in the marketing of goods or services," by denoting the relationship as a "community of interest." Since common interest in the marketing of goods or services is the basis for the franchise, fiduciary duties could be found to pervade the entire relationship.⁸⁸

The "community of interest" requirement, however, could lead to some ambiguity. Since courts have not accepted the argument that fiduciary duties exist in the "traditional" franchise relationship,⁸⁹ it

⁸² Mass. Senate Bill 110, § 1(a) (1971). See Cal. Assembly Bill 230, § 4 (1971) (amending Cal. Corp. Code § 31005); N.J. Assembly Bill 2063, § 3(a) (1971); Vt. Senate Bill 82, § 1(1) (1971). Connecticut has a similar "community of interest" provision. Conn. Substitute Senate Bill 1474, § 1(2) (1971).

⁸³ *Carboneau v. Peterson*, 95 P.2d 1043, 1055, 1 Wash. 2d 347, 376 (1939).

⁸⁴ *Brown*, supra note 43, at 664. But see *Jirna, Ltd. v. Mister Donut of Canada, Ltd.* [1971] 13 D.L.R.3d 645 (1970), rev'd, 1 Karas Exec. Rep. No. 14, at 1 (Oct. 11, 1971).

⁸⁵ See *Jackson v. Ludeling*, 88 U.S. (21 Wall.) 616 (1874); *Wheeler v. Abilene Nat'l Bank Bldg. Co.*, 159 F. 391 (8th Cir. 1908); *Jones v. Missouri-Edison Elec. Co.*, 144 F. 765 (8th Cir. 1906); *Booker v. Crocker*, 132 F. 7 (8th Cir. 1904).

⁸⁶ *Jackson v. Ludeling*, 88 U.S. (21 Wall.) at 622 (1874). See *Wheeler v. Abilene Nat'l Bank Bldg. Co.*, 159 F. 391, 393 (8th Cir. 1908); *Jones v. Missouri-Edison Elec. Co.*, 144 F. 765, 771 (8th Cir. 1906); *Booker v. Crocker*, 132 F. 7, 8 (8th Cir. 1904).

⁸⁷ *Booker v. Crocker*, 132 F. 7, 8 (8th Cir. 1904). See *Wheeler v. Abilene Nat'l Bank Bldg. Co.*, 159 F. 391, 393 (8th Cir. 1908); *Jones v. Missouri-Edison Elec. Co.*, 144 F. 765, 771 (8th Cir. 1906).

⁸⁸ Compare Ill. Substitute House Bill 2763, § 29 (1971) and Tex. Senate Substitute for House Bill 709 § 18.06 (1971). See text infra at p. 558.

⁸⁹ But see *Jirna, Ltd. v. Mister Donut of Canada, Ltd.*, [1971] 13 D.L.R.3d 645 (1970) (holding fiduciary relationship to exist between franchisor and franchisee), rev'd 1 Karas Exec. Rep., No. 14, at 1 (Oct. 11, 1971).

may follow that no "community of interest" exists between the franchisor and franchisee. By requiring a "community of interest" between the parties in order that their relationship may be included within the statutory definition, the Massachusetts legislature may have excluded from coverage every traditional franchise relationship. However, it does not appear that this construction comports with the intent of the legislature.⁹⁰

On the other hand, it may be contended that if the statutory definition does not require fiduciary duties as a prerequisite to inclusion within the definition, the definition cannot impliedly impose such duties on relationships otherwise within the statutory coverage, since the provision would thereby become superfluous. Under proper rules of statutory construction a court would refrain from a construction of the definition which would render unnecessary a substantive provision of the bill. This argument cannot prevail, however, in light of the specific language of section 5 of the bill which, without limiting other provisions, requires good faith and forbids arbitrary, capricious or unconscionable dealings as being unfair or deceptive practices.⁹¹ Under section 7 of the Massachusetts bill, the attorney general may utilize judicial proceedings to enforce violations of the statute.⁹² While the imposition of fiduciary duties would prohibit arbitrary, capricious and unconscionable dealings as well as require a higher standard of conduct than "good faith," breach of the fiduciary duties would not necessarily subject the party to the judicial sanctions of the attorney general. On the other hand, a breach of fiduciary duties which does not amount to a breach of good faith or to arbitrary, capricious or unconscionable dealings could subject the franchisor to liability under section 7(b) of the bill.⁹³ Despite its potential ambiguity, the Massachusetts definition can be interpreted as employing a sweeping approach which involves limited definitional requirements, while at the same time creating a broad base for statutory duties and responsibilities.

A second example of the first approach to defining the legislative scope is the definition contained in the California Franchise Investment Act:

⁹⁰ Statement of Harold Brown, app. B, Commentary on Proposed [Massachusetts] Franchise Fair Dealing Statute (Mass. House Bill 2279), 1970 Hearings, *supra* note 69, at 2, 28. Although this statement was made with reference to the original proposed Mass. bill, the provisions of the present Mass. bill as substantially similar. "[T]he proposed definition is all inclusive . . ." *Id.*

⁹¹ Mass. Senate Bill 110, § 5(a) (1971). See Cal. Assembly Bill 230, § 24 (1971) (amending Cal. Corp. Code § 31250); Vt. Senate Bill 82, § 4(1) (1971). Washington merely requires "good faith" dealing. See Rev. Code Wash. Ann. ch. 252, § 18(1) (Supp. 1971).

⁹² Mass. Senate Bill 110, § 7(a) (1971). See similarly Vt. Senate Bill 82, § 6(a) (1971).

⁹³ Mass. Senate Bill 110, § 7(b) (1971). See similarly Vt. Senate Bill 82, § 6(b) (1971).

"Franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

- (a) A franchise [*sic*] is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and
- (b) The operation of the franchisee's business pursuant to such a plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logo-type, advertising or other commercial symbol designating the franchisor or its affiliate; and
- (c) The franchisee is required to pay directly or indirectly, a franchise fee.⁹⁴

This definition has been considered by some authorities as preferable to the Massachusetts definition because the definitional requirements are specified in greater detail and therefore the scope of the definition is not as broad. They feel that the Massachusetts definition encompasses "many relationships which are not franchises in the accepted sense. . . ."⁹⁵ Although this may be true, the lack of breadth of the California Act may so limit the law's application as to diminish its effectiveness.

In paragraphs (a) and (b) of the California definition a potential problem exists in the use of the word "substantial." The problem is especially severe with respect to subsection (a). It may be possible for a franchisor to exempt himself from the statutory definition by carefully limiting the extent to which he controls his franchisees. At the least this language presents the undesirable prospect of protracted litigation before its meaning is established.

Requiring a fee as a prerequisite to the existence of the statutorily regulated franchise relationship is also an undesirable limitation.⁹⁶ Not only does this requirement exclude many existing franchises from the statutory definition,⁹⁷ but it presents franchisors with the temptation to exempt themselves from statutory regulation⁹⁸ by elimination of

⁹⁴ Cal. Corp. Code § 31005 (West Supp. 1971). See Ga. Senate Bill 124, § 3(c) (1971); N.J. Assembly Bill 2293, § 3(b) (1971); N.J. Senate Bill 2158, § 3(b) (1971); Kan. Senate Bill 243, § 2(c) (1971); Ohio Senate Bill 295 § 1705.01(D) (1971); Wis. Senate Bill 784, § 553.03(4)(a) (1971).

⁹⁵ See Minister's Committee Report, *supra* note 80, at 37.

⁹⁶ *Id.*

⁹⁷ Texas and Illinois, which employ definitions similar to that of California, compounded this danger by adding the requirement that the fee be "in excess of \$100." Tex. Senate Substitute House Bill 709 § 18.03(1)(c) (1971); Ill. Substitute House Bill 2763 § 2(c) (1971).

⁹⁸ Minister's Committee Report, *supra* note 80, at 38. See, e.g., *Siegel v. Chicken Delight, Inc.* 311 F. Supp. 847 (N.D. Cal. 1970), *aff'd in part and rev'd in part*, 448 F.2d 43 (9th Cir. 1971). The district court, noting that the contracts and written representations by Chicken Delight stated that there were no franchise fees or royalty payments, concluded that the payments made to Chicken Delight by the franchisees were solely in

the franchise fee and recovery of its equivalent in other ways.⁹⁹ It may be true that avoidance in this manner is not possible due to the inclusion within the statute of the word "indirectly." Nevertheless, difficult factual issues again present the prospect of extensive litigation before adequate guidelines may be established.

Some states have attempted to reach a compromise between the broad definition used by Massachusetts and the more detailed California definition. The Washington statute presents an example of such an attempt:

"Franchise" means an oral or written contract or agreement, either expressed or implied, in which a person grants to another person, a license to use a tradename, service mark, trade mark, logotype or related characteristic in which there is a community interest in the business of offering, selling, distributing goods or services at wholesale or retail, leasing, or otherwise and in which the franchisee is required to pay, directly or indirectly, a franchise fee.¹⁰⁰

At first glance the definition appears weakened by the inclusion of a franchise fee requirement similar to that contained in the California law. Unlike the California law, however, the Washington Act goes on to define "franchise fee" to include any payment of an initial capital investment fee, any fee based upon a percentage of sales, training fee, payment for services, or payment for rent, goods or supplies which exceeds the fair market value of the item.¹⁰¹ By extending the definition of franchise fee to include virtually every type of payment a franchisee could make to a franchisor, the Washington law has increased the scope of its definition beyond that of the California law, while at the same time limiting its definition to those situations where a franchisor in some way receives payment for the use of his trademark. Thus where the Massachusetts definition includes within its scope the mere use of a franchisor's tradename, Washington additionally requires some

payment for the tied items. The court refused to consider the overcharges on these tied items as indirect royalty payments and concluded that as a matter of law the overcharges should be the measure of damages. "This Court will not attempt to restructure the system of defendants [Chicken Delight] into one which is legally constituted and then allow an offset for imaginary or suppositious royalty fees." 311 F. Supp. 847, 852 (N.D. Cal. 1970). On appeal the Court of Appeals for the Ninth Circuit reversed as to the measure of damages, stating that "neither the existence of damage nor its lack of existence has been established as a matter of law. . . ." 448 F.2d 43, 53 (9th Cir. 1971).

⁹⁹ "There are eight main ways in which the franchisors secure revenue. These include: initial franchise fee; royalties; rental of premises; sale or leasing of equipment, supplies and raw materials; sale of franchise products; [and] sale of territorial rights." Woll, Sources of Revenue to the Franchisor and their Strategic Implications, 44 J. Retailing No. 4, at 14 (1968). Any one of the latter seven-ways could be used to supplant the franchise fee.

¹⁰⁰ Rev. Code Wash. Ann. ch. 252, § 1(4) (Supp. 1971).

¹⁰¹ Rev. Code Wash. Ann. ch. 252, § 1(4) (Supp. 1971). Compare Cal. Corp. Code § 31011 (West Supp. 1971).

payment for the use of the trademark, regardless of the form the payment may take.

A possible similarity between the Washington and Massachusetts definition is the use of the phrase "community interest" in the Washington law. However, since this language is defined in another section of the Washington Act as "a continuing financial interest,"¹⁰² a court could find that because the legislature provided a definition, the judiciary should not look to the common law for guidance but rather should accept this definition as an expression of legislative intent. Thus there would not appear to be the same potential for statutorily created fiduciary duties in the Washington law as there is in the Massachusetts bill. Finally, the Washington definition appears to provide the best balance to date between the broad Massachusetts definition and the restrictive California definition.

A franchise law recently enacted in Florida defines a franchise as a commercial relationship made pursuant to an oral or written contract "[w]herein the operation of the franchisee's business franchise is substantially reliant on franchisors for the basic supply of goods."¹⁰³ Not only is this requirement fraught with the potential for litigation to establish when a franchisee is "*substantially reliant*" on a franchisor, and to establish what is a "*basic supply of goods*," but on its face this requirement appears to exclude virtually all franchises in which the franchisor, in an attempt to prevent antitrust suits, permits his franchisees to purchase their goods from third parties. Here, then, the possibility of escaping regulation is potentially as strong as it is with California's franchise fee requirement.

New York's pending disclosure bill provides a definition of "franchise" similar to that of Florida. Of the four provisions characterizing a franchise in the New York bill, the fourth requires that

the operation of the franchisee's business is substantially reliant upon the franchisor for the continued supply of goods, services, guidance or direction.¹⁰⁴

This definition will also require litigation to determine its meaning, including what franchisor assistance is included in the terms "guidance or direction" and how long the assistance and supplies must be given in order to be "continued." Finally, unlike that of Washington, neither the Florida nor the New York definition adequately reflects the dominant characteristic of franchising: that it is a marketing system wherein a franchisor, while not necessarily actively participating in the marketing, grants a franchisee, in return for some form of payment, the right to operate a business selling or distributing goods or services under the franchisor's trademark.

¹⁰² Rev. Code Wash. Ann. ch. 252, § 1(2) (Supp. 1971).

¹⁰³ Fla. Stat. Ann. ch. 71-61, § 1(2) (Supp. 1971). In addition, the definition requires that the franchisee be a component of a franchisor's distribution system.

¹⁰⁴ N.Y. Senate Bill 2321 (Assembly Bill 2649), § 681(1)(d) (1971). See similar Conn. Substitute Senate Bill 1474, § 1(4) (1971).

B. *Legislative Scope: Statutory Exemptions*

Most franchise legislation provides exemptions, based on specific criteria, for franchisors who would otherwise be included in the statutory definition and subject to regulation. Some experts feel that exemptions are needed due to the long, trouble-free existence of certain franchises.¹⁰⁵ Some exemptions are based upon net worth, the prior business experience of the franchisor's principals, and a "grandfather concept" which exempts franchisors who have been selling franchises for a specified number of years.¹⁰⁶

The California disclosure law exempts from the registration requirements franchisors who (a) have a consolidated net worth of not less than five million dollars or a consolidated net worth of not less than one million dollars if they are at least eighty percent owned by a corporation whose net worth is not less than five million dollars; (b) have had at least twenty-five franchisees conducting business in the state for five years prior to the offer, or have conducted business which is the subject of the franchise for the five years prior to the offer; and (c) make written disclosures to each prospective franchisee at least forty-eight hours prior to the sale.¹⁰⁷ The Washington law has a similar exclusion with a further limitation requiring that the franchisor compel an initial investment of more than one hundred thousand dollars from the franchisee.¹⁰⁸ The exemption requirements of the proposed Illinois law are similar to those in the California law; however, the net worth requirement is reduced to two million dollars, and the disclosures to the franchisee are required to be made seventy-two hours prior to the sale.¹⁰⁹ In each case the granting of exemptions is based upon the fallacious assumption that a franchisor characterized by size, age, or wealth, or by the fact that he requires a large invest-

¹⁰⁵ See A. Pierno, *Franchise Regulation—The Need for a New Approach*, 44 Los Angeles B. Ass'n Bull. 501, 505, 534 (1969).

¹⁰⁶ *Id.* at 534.

¹⁰⁷ Cal. Corp. Code § 31101 (West Supp. 1971). See N.J. Assembly Bill 2293, § 5 (1971); N.J. Senate Bill 2158, § 5 (1971); Kan. Senate Bill 243, § 4 (1971); Ohio Senate Bill 295, § 1705.04 (1971); Ga. Senate Bill 124, § 5 (1971). However, the Georgia proposal appears to have a word change which substantially alters the requirements for exemption: use of the word "or" instead of "and" after requirement (b) makes the requirements for exemption alternative rather than collective.

¹⁰⁸ Rev. Code Wash. Ann. ch. 252, § 3(4)(c) (Supp. 1971).

¹⁰⁹ Ill. Substitute House Bill 2763, § 5 (1971). See Wis. Senate Bill 784, § 553.22 (1971), where the net worth requirement is also two million dollars but requiring that only ten franchisees need have conducted business for five years prior to the offer.

The New Jersey termination bill also provides for exemptions. Excluded are franchises in which the gross sales of products or services between the franchisor and franchisee do not exceed \$35,000 during the twelve-month period preceding the institution of a suit by a franchisee, and where less than 20% of the franchisee's gross sales were derived from the franchise. N.J. Assembly Bill 2063, § 4 (1971). "Under these provisions, application of the statute could depend upon when suit is filed." Report of Lewis Rudnick, 4th Annual Franchising and Government Symposium of the IFA, May 17, 18 and 19, 1971, at 21-22.

ment by the franchisee, will not take undue advantage of franchisees or abuse the franchise relationship. The fallacy in these assumptions lies in equating the above attributes with "honesty."¹¹⁰ As a matter of fact, the many problems resulting from contractual inequality are almost by their nature indigenous to large corporations¹¹¹ and it is these large franchise corporations which are most likely to meet the above exemption requirements.

The pending New York disclosure bill grants the attorney general, to whom supervision of the law would be entrusted, discretion in determining which franchisees to exempt from the registration and disclosure requirements, provided that the exemptions are "not inconsistent with the public interest or the protection of potential or existing franchisees."¹¹² This exemption provision is more flexible than those previously discussed because it places the right to grant exemptions with the person to whom enforcement of the law is entrusted, the one in the best position to determine which franchisors, if any, should be exempted.

The pending Connecticut bill provides that the law's requirement of "due cause" for termination or refusal to renew shall not apply to those written franchises "containing provisions for the binding arbitration of disputes as to due cause in accordance with the rules of the American Arbitration Association. . . ."¹¹³ Arbitration has been effectively used in other business contexts and should also be effective in the franchise relationship.¹¹⁴ Arbitration's most evident attribute is that it can be used to prevent litigation that is costly to both the franchisor and the franchisee involved. An exemption provision of this nature is justifiable since it does not attempt to exempt arbitrarily some franchisors from all regulation; it merely provides a relatively informal and inexpensive method of disposition for one limited category of disputes.

The various definitions of the term "franchise" and the numerous franchisor exemptions represent state attempts to draw within the scope of regulation the desired range of business operations. Once the scope of the law is established, the state legislatures have available a variety of approaches to remedying franchise abuses. The first legislative approach to be discussed will be that of disclosure legislation.

C. *The Franchise Relationship Begins: Disclosure Legislation*

Most franchise legislation to date has dealt with the initiation of the franchise relationship. It is at this point that the problems of mis-

¹¹⁰ See Brown, *Franchising: Legislating Full Disclosure, Good Faith and Fair Dealing*, 15 Boston B.J. No. 8 at 15, 20 (1971).

¹¹¹ Minister's Committee Report, *supra* note 80, at 38.

¹¹² N.Y. Senate Bill 2321 (Assembly Bill 2649), § 682(8) (1971).

¹¹³ Conn. Substitute Senate Bill 1474, § 4 (1971). Implicit in this exemption is a requirement that the franchise agreement prohibit termination and nonrenewal "except for due cause."

¹¹⁴ See Rudnick, *Arbitration of Disputes Between Franchisors and Franchisees*, 55 Illinois B.J. 54 (1966).

representation, deceptive advertising, and criminal involvement can be dealt with best. This body of legislation is known as disclosure law. The theory behind it is most ably described by Justice Brandeis' statement that "publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants. . . ."¹¹⁵

California was the first state to enact a disclosure law, one which may serve as a basis for comparison to other such laws.¹¹⁶ This law requires the registration of all but exempt franchise offerings with the Commissioner of Corporations.¹¹⁷ Failure to register may render the franchisor liable to the franchisee for damages, and if the violation is willful, for rescission as well.¹¹⁸ In addition, the information contained in the registration form must be disclosed to prospective franchisees in a prospectus¹¹⁹ at least forty-eight hours prior to the sale of the franchise.¹²⁰ To supplement the registration and disclosure requirements, the law provides for active regulation by the Commissioner. If the franchisor has failed to demonstrate that adequate financial arrangements have been made to fulfill his obligations under the offering, the Commissioner may place in escrow the franchise fees until the opening of the franchise business, in order to protect prospective franchisees.¹²¹

¹¹⁵ L. Brandeis, *Other People's Money* 92 (1932).

¹¹⁶ Cal. Corp. Code tit. 4, div. 5 (West Supp. 1971). See Ga. Senate Bill 124 (1971); Ill. Substitute House Bill 2763 (1971); N.J. Assembly Bill 2293 (1971); N.J. Senate Bill 2158 (1971); N.Y. Senate Bill 2321 (Assembly Bill 2649) (1971); Kan. Senate Bill 243 (1971); Ohio Senate Bill 295 (1971); Rev. Code Wash. Ann. ch. 252 (Supp. 1971); Wis. Senate Bill 784 (1971).

¹¹⁷ Cal. Corp. Code § 31110 (West Supp. 1971). See Ga. Senate Bill 124, § 7 (1971); Ill. Substitute House Bill 2763, § 7 (1971); N.J. Assembly Bill 2293, § 8 (1971); N.J. Senate Bill 2158, § 8 (1971); N.Y. Senate Bill 2321 (Assembly Bill 2649), § 682 (1971); Kan. Senate Bill 243, § 7 (1971); Ohio Senate Bill 295, § 1705.03 (1971); Rev. Code Wash. Ann. ch. 252, § 2 (Supp. 1971); Wis. Senate Bill 784, § 553.21(1) (1971).

¹¹⁸ Cal. Corp. Code § 31300 (West Supp. 1971). See Ga. Senate Bill 124, § 36 (1971); Ill. Substitute House Bill 2763, § 35 (1971); N.J. Assembly Bill 2293, § 36 (1971); N.J. Senate Bill 2158, § 36 (1971); Kan. Senate Bill 243, § 36 (1971); Ohio Senate Bill 295, § 1705.22 (1971). See also Rev. Code Wash. Ann. ch. 252, § 19(2) (Supp. 1971); Wis. Senate Bill 784, § 553.51(1) (1971). Washington and Wisconsin permit an action for rescission even if the violation is not willful. Note that no private right of action is given franchisees by N.Y. Senate Bill 2321 (Assembly Bill 2649) (1971).

¹¹⁹ Cal. Corp. Code § 31114 (West Supp. 1971). See Ga. Senate Bill 124, § 11 (1971); Ill. Substitute House Bill 2763, § 11 (1971); N.J. Assembly Bill 2293, § 12 (1971); N.J. Senate Bill 2158, § 12 (1971); N.Y. Senate Bill 2321 (Assembly Bill 2649), § 682(6) (1971); Kan. Senate Bill 243, § 11 (1971); Ohio Senate Bill 295, § 1705.07 (1971); Wis. Senate Bill 784, § 553.27(3) (1971).

¹²⁰ Cal. Corp. Code § 31119 (West Supp. 1971). See Ga. Senate Bill 124, § 16 (1971); N.J. Assembly Bill 2293, § 17 (1971); N.J. Senate Bill 2158, § 17 (1971); Kan. Senate Bill 243, § 16 (1971); Ohio Senate Bill 295, § 1705.13 (1971); Wis. Senate Bill 784, § 553.27(4) (1971). Illinois requires 72 hours. Ill. Substitute House Bill 2763, § 17 (1971). See also Rev. Code Wash. Ann. ch. 252, § 8 (Supp. 1971). The New York statute has no time requirement.

¹²¹ Cal. Corp. Code § 31113 (West. Supp. 1971). A surety bond is permitted as an alternative to the escrow procedure at the option of the franchisor. See Ga. Senate Bill

The benefit of the escrow provision is that it gives the Commissioner latitude in cases where the legitimacy of the franchisor is questionable. If the franchisor satisfies his obligations, he receives the escrowed funds; if not, the franchise fee is returned to the franchisee.¹²² In addition, the Commissioner may issue a stop order denying the effectiveness of the franchisor's registration if the franchisor has failed to comply with any of the provisions of the law; or, more importantly, if the offer or sale of the franchise would constitute misrepresentation to, or deceit or fraud upon, the purchaser; or, finally, if the Commissioner finds that the criminal background of any person associated with the franchisor creates an unreasonable risk to prospective franchisees.¹²³

The key section of the law, which has been copied almost verbatim by other states, contains twenty-two paragraphs specifying information required in the registration form.¹²⁴ For example, a statement disclosing the identity and experience of persons affiliated with the franchisor is required, as is a statement as to whether any one of the identified persons has been convicted of a felony, or has had a civil judgment entered against him (if the felony or civil action involved fraud, embezzlement or misappropriation of property), or is subject

124, § 10 (1971); Ill. Substitute House Bill 2763, § 10 (1971); N.J. Assembly Bill 2293, § 11 (1971); N.J. Senate Bill 2158, § 11 (1971); Kan. Senate Bill 243, § 10 (1971); Ohio Senate Bill 295, § 1705.10 (1971); Wis. Senate Bill 784, § 553.27(2) (1971). See also Rev. Code Wash. Ann. ch. 252, § 5 (Supp. 1971). New York requires the franchisor to hold all payments made by a franchisee prior to the commencement of operation in a trust so that these funds cannot be commingled with the franchisor's personal assets. The funds are held in trust until applied to the purposes stated in the registration. N.Y. Senate Bill 2321 (Assembly Bill 2649), § 683 (1971).

¹²² Statement of Clark Bradley, California State Senator [hereinafter cited as Bradley, 1970 Hearings] from Hearings on the Impact of Franchising on Small Business Before the Subcomm. on Urban and Rural Economic Development of the Senate Select Comm. on Small Business, 91st Cong., 2d Sess., pt. 2, at 2 (1970) [hereinafter cited as 1970 Hearings]. There are others, however, who feel that the provision will be used to place into escrow all franchise fees until the franchise business is delivered, a practice which, it is felt, would place the franchisor in a difficult position if he needed the escrowed fees to equip the franchisee's business. Augustine & Hrusoff, *supra* note 78, at 1380. The alternative procedure of supplying a surety bond may overcome this objection.

¹²³ Cal. Corp. Code § 31115 (West Supp. 1971). See Ga. Senate Bill 124, § 12 (1971); Ill. Substitute House Bill 2763, § 12 (1971); N.J. Assembly Bill 2293, § 13 (1971); N.J. Senate Bill 2158, § 13 (1971); Kan. Senate Bill 243, § 12 (1971); Ohio Senate Bill 295, § 1705.11(A) (1971). See also, Wis. Senate Bill 784, § 553.28(1) (1971). The Washington law contains additional bases for issuing a stop order: (a) where the franchise offering sought to be registered is the subject of a permanent or temporary injunction; (b) where the business or method of business would include activities which are illegal where performed. Rev. Code Wash. Ann. ch. 252, § 12 (Supp. 1971). Cf. N.Y. Senate Bill 2321 (Assembly Bill 2649), § 686 (1971).

¹²⁴ Cal. Corp. Code § 31111 (West Supp. 1971). See Ga. Senate Bill 124, § 8 (1971); Ill. Substitute House Bill 2763, § 8 (1971); N.J. Assembly Bill 2293, § 9 (1971); N.J. Senate Bill 2158, § 9 (1971); Kan. Senate Bill 243, § 8 (1971); Ohio Senate Bill 295, § 1705.06 (1971); Rev. Code Wash. Ann. ch. 252, § 4 (Supp. 1971); Wis. Senate Bill 784, § 553.26 (1971). New York's registration provision is substantially similar. N.Y. Senate Bill 2321 (Assembly Bill 2649), § 682(2) (1971).

to any currently effective order of the Securities and Exchange Commission (SEC) or the Federal Trade Commission (FTC). The franchisor must provide a recent financial statement and a copy of a typical franchise contract. He must describe any fees, franchise or otherwise, which are payable by the franchisee. He must disclose conditions for renewal or termination. He must also disclose which goods and services must be purchased from the franchisor, and which goods or services the franchisee is limited to offering. The franchisor is required to state the terms of any financing provided for the franchisee, and he must enclose a copy of any statement of estimated or projected franchise earnings. The franchisor must disclose the number of franchisees presently operating, the number yet to be sold, and whether the franchisee receives an exclusive area. Finally, any additional information required by the Commissioner must be filed and any information desired to be filed by the franchisor may be included.¹²⁵

A copy of the prospectus which is sent to potential franchisees must be attached to the registration application.¹²⁶ The prospectus must contain most of the disclosures required in the application for registration. The only major disclosures specifically not required to be made in the prospectus relate to the criminal record of those persons associated with the franchisor.¹²⁷ Since the Commissioner is able to deny or suspend the franchisor's registration if he feels that a history of criminal activity would create an unreasonable risk to the franchisee, the prospective franchisee is protected even though the disclosure was not made directly to him.

Although exempt franchisors are not required to register, they must make limited disclosures directly to the franchisee.¹²⁸ These disclosures are the same as those required in the registration application with the exclusion of several important paragraphs. The excluded paragraphs are those which would require a recent financial statement of the franchisor, identification of those affiliated with the franchisor, information as to the business experience of the franchisor, and statements as to whether the franchisor or his associates have been

¹²⁵ Statutes cited, note 124 supra.

¹²⁶ Statutes cited, note 119 supra.

¹²⁷ Cal. Corp. Code § 31114 (West Supp. 1971). See Ga. Senate Bill 124, § 11 (1971); Ill. Substitute House Bill 2763, § 11 (1971); N.J. Assembly Bill 2293, N.J. Senate Bill 2321 (Assembly Bill 2649), § 682(2) (1971); § 12 (1971); N.J. Senate Bill 2158, § 12 (1971); Kan. Senate Bill 243, § 11 (1971); Ohio Senate Bill 295, § 1705.07 (1971). Such information is considered by franchisor representatives to be "sensitive." Rudnick, *supra* note 109, at 6. This exception does not exist under the Washington and Wisconsin laws. See Rev. Code Wash. Ann. ch. 252, § 8 (Supp. 1971); Wis. Senate Bill 784, § 553.27(3) (1971).

¹²⁸ Cal. Corp. Code § 31101(c)(1)-(14) (West Supp. 1971). See Ga. Senate Bill 124 § 5(c)(1)-(14) (1971); Ill. Substitute House Bill 2763, § 5(c)(1)-(19) (1971); N.J. Assembly Bill 2293, § 5(c)(1)-(14) (1971); N.J. Senate Bill 2158, § 5(c)(1)-(14) (1971); Kan. Senate Bill 243, § 4(c)(1)-(14) (1971); Ohio Senate Bill 295, § 1705.04(c)(1)-(14) (1971); Rev. Code Wash. Ann. ch. 252, § 3(4)(d)(i)-(xvi) (Supp. 1971); Wis. Senate Bill 784, § 553.22(3)(a)-(n) (1971).

convicted of a criminal offense, held liable in a civil action relating to fraud, or subject to an order of the SEC or FTC.¹²⁹ Since this information is not readily available to the franchisee from any other source, the exclusion means that the prospective franchisee can unknowingly buy a franchise from a bankrupt franchisor or from one who has a criminal background. Not only is the franchisee of an exempt franchisor not protected from these abuses by the escrow provision or stop orders of the Commissioner, but the franchisee cannot even determine for himself whether the franchisor has "adequate financial arrangements" or if the franchise is subject to "unreasonable risks" because the disclosures from which the franchisee could glean this information are specifically excluded from the disclosure requirements. It is not unreasonable that certain information remains undisclosed to the franchisee when he is protected by the full sweep of registration. However, when this safeguard is not available, as in the case of the exempt franchisor, the franchisor's right to privacy should fall and disclosure of criminal records to the franchisee should be required.¹³⁰

Although the registration and disclosure requirements of the Washington law are substantially similar to those of California, the provisions providing for active regulation by the Director, Washington's counterpart of the California Commissioner, are more liberal. Under the Washington law the Director may place into escrow all franchise fees "if he finds that such requirement is necessary and appropriate to protect prospective franchisees,"¹³¹ and not solely because he questions the franchisor's financial arrangements, as in the California law.

Another prefranchise regulation to be found in disclosure legislation involves advertising. It provides that no franchise advertisement may be published unless a copy of the advertisement has been filed with the state prior to publication.¹³² Furthermore, no advertisement may be published if it is found to contain any false or misleading statements or if it omits any statements necessary to prevent the

¹²⁹ Compare statutes cited at note 124 with statutes cited at note 128. Note that New York does not have required disclosures for exempt franchisors. But see the Illinois statute which excludes only the recent financial statement of the franchisor. Ill. Substitute House Bill 2763, § 5(c) (1971).

¹³⁰ The New York proposal does not require the franchisor's criminal history to be disclosed to the franchisee, but it must be included in the "franchisor registration" statement which must be filed with the attorney general's office. N.Y. Senate Bill 2321 (Assembly Bill 2649), § 682(1) and (2) (1971). If the attorney general utilizes his power to exempt franchisors from the registration requirements of the bill, he should require the franchisor, thereby exempted from registration, to disclose all material information, including criminal history, to the franchisee.

¹³¹ Rev. Code Wash. Ann. ch. 252, § 5 (Supp. 1971).

¹³² Cal. Corp. Code § 31156 (West Supp. 1971). See Ga. Senate Bill 124, § 28 (1971); Kan. Senate Bill 243, § 28 (1971); N.J. Assembly Bill 2293, § 28 (1971); N.J. Senate Bill 2158, § 28 (1971); N.Y. Senate Bill 2321 (Assembly Bill 2649), § 682(4) (1971); Wash. Ann. ch. 252, § 10 (Supp. 1971); Wis. Senate Bill 784, § 553.53 (1971).

advertisement from being misleading.¹³³ A similar provision has been successfully used under California's Corporate Securities Law.¹³⁴

Although the disclosures required in both pending and enacted disclosure legislation of other states are substantially similar to those of California, variation in approach does exist. For example, the disclosures required of franchisors under the Texas bill are made directly to the franchisee; there is no registration requirement.¹³⁵ This regulatory approach relies exclusively on private enforcement by franchisees through litigation. Under the liability section of the Texas bill, a franchisee may sue for damages if the disclosure is misleading or untrue and, if the violation is willful, he may sue for rescission.¹³⁶

The Florida disclosure law also requires limited disclosures directly to the franchisee. The provisions of the law prohibit intentional misrepresentation by failure to disclose the known required total investment for the franchise or by failure to disclose efforts to sell or establish more franchises than the market may reasonably be expected to sustain.¹³⁷ Furthermore, it is unlawful under the Florida statute to misrepresent intentionally the prospects of a proposed or existing franchise.¹³⁸ Enforcement is limited to a civil action for rescission with the right to recover reasonable attorney's fees.¹³⁹

Texas and Florida both utilize the direct disclosure approach to compensate for the fact that they do not maintain adequate administrative machinery to implement effectively a disclosure law requiring that the franchisor register with a state department.¹⁴⁰ This administrative difficulty is just one of the many reasons that experts insist upon the necessity of a single federal franchise law.¹⁴¹ Until such

¹³³ Cal. Corp. Code § 31157 (West Supp. 1971); Ga. Senate Bill 124, § 29 (1971); Kan. Senate Bill 243, § 29 (1971); N.J. Assembly Bill 2293, § 29 (1971); N.J. Senate Bill 2158, § 29 (1971); Rev. Code Wash. Ann. ch. 252, § 11 (Supp. 1971). The pending Connecticut bill provides that "no franchisor shall . . . engage . . . in methods of competition with any franchisee which constitutes unfair methods of competition within the meaning of the Federal Trade Commission Act [FTCA]." Conn. Substitute Senate Bill 1474, § 5 (1971). Deceptive advertising of all types falls within the scope of the Federal Trade Commission's jurisdiction. Although the FTCA does not provide a remedy to the individual who has been defrauded, in recent cases the FTC has ordered refunds to deceived franchisees. See, e.g., Universal Credit Acceptance Corp., 3 Trade Reg. Rep. ¶ 19,340 (1970); Universal Electronics Corp., 3 Trade Reg. Rep. ¶ 19,390 (1970). See Glickman, *Franchising*, § 8.02[1] (1971).

¹³⁴ Bradley, 1970 Hearings, *supra* note 122, at 602.

¹³⁵ Tex. Senate Substitute House Bill 709, § 18.04 (1971). The disclosures required are substantially similar to the disclosures required in the California registration application. Due to the absence of administrative regulation, disclosure of the criminal history of the franchisor's principal officers is required. *Id.* at § 18.04(b)(5).

¹³⁶ Tex. Senate Substitute House Bill 709, § 18.07(a) (1971).

¹³⁷ Fla. Stat. Ann. ch. 71-61, § 2(1)(b) & (c) (Supp. 1971).

¹³⁸ Fla. Stat. Ann. ch. 71-61, § 2(1)(a) (Supp. 1971).

¹³⁹ Fla. Stat. Ann. ch. 71-61, § 3 (Supp. 1971).

¹⁴⁰ Rudnick, *supra* note 109, at 4-5.

¹⁴¹ *Id.* at 5; cf. Augustine & Hrusoff, *Franchise Regulation*, 21 *Hast. L. J.* 1347, 1382 (1970).

legislation is enacted, state disclosure legislation must be relied upon, whether it be of the direct type such as the Texas law, involving slow and potentially inconsistent judicial proceedings, or the registration type such as the Washington Franchise Investment Protection Act.

Finally, the enforcement provisions of the disclosure laws should be examined. If the franchisor violates an exemption or registration provision the franchisee may sue for damages. If the violation is wilful, he may sue for rescission as well. The same remedies are provided if the franchisor makes an untrue statement or omission of a material fact.¹⁴² However, these laws also provide that if the franchisor can prove that the franchisee "knew the facts concerning the untruth or omission, or that the [franchisor] exercised reasonable care and did not know, or, if he had exercised reasonable care would not have known of the untruth or omission," the action can be defeated.¹⁴³ One critic considers this defense to be a serious weakness in the effectiveness of the law: this is "the first time that contributory negligence has been made a defense to fraud."¹⁴⁴ A further weakness in these enforcement provisions is the limitation of recovery to actual damages. Because franchisors need only fear the loss of their ill-gotten gains, they may not be dissuaded from illegality. This limitation on recovery is also undesirable because the franchisee is not sufficiently protected from losses that are not included in the category of "actual damages." Whatever equitable interest the franchisee may have built up in the business may be unrecoverable.

Proponents of the Washington disclosure law, however, believe that it avoids these shortcomings.¹⁴⁵ Under this law a court in its discretion may increase the award of damages to an amount "not to exceed three times the actual damages sustained" or may grant any other relief it considers appropriate.¹⁴⁶ The statute, however, retains the franchisor's defense of contributory negligence in an action for rescission based upon fraudulent misstatement or omission, although it does not retain this defense in an action for damages.¹⁴⁷ Granting the franchisor this defense in an action for rescission is equitable be-

¹⁴² Cal. Corp. Code §§ 31300 & 31301 (West Supp. 1971); Ga. Senate Bill 124, §§ 36 & 37 (1971); Ill. Substitute House Bill 2763, §§ 35 & 36 (1971); Kan. Senate Bill 243, §§ 36 & 37 (1971); N.J. Assembly Bill 2293, §§ 36 & 37 (1971); N.J. Senate Bill 2158, §§ 36 & 37 (1971); Ohio Senate Bill 295, §§ 1705.22 & 1705.23 (1971); Tex. Senate Substitute House Bill 709, § 18.07 (1971); Wis. Senate Bill 784, § 553.51(1) & (2) (1971). But see Rev. Code Wash. Ann. ch. 252, § 19 (Supp. 1971).

¹⁴³ See statutes cited in note 142 *supra*.

¹⁴⁴ Brown, *Franchising: Legislating Full Disclosure, Good Faith and Fair Dealing*, 15 Boston B.J. No. 8, at 15, 20 (1971). While this statement may be an oversimplification, the liability provisions are unduly complicated and at times appear incapable of consistent application.

¹⁴⁵ *Id.*

¹⁴⁶ Rev. Code Wash. Ann. ch. 252, § 19(3) (Supp. 1971).

¹⁴⁷ Rev. Code Wash. Ann. ch. 252, § 19(2) (Supp. 1971). See Wis. Senate Bill 784, § 553.51(1) (1971).

cause the franchisee should not be permitted to escape his obligations under the contract after he has been negligent in entering into it. At the same time, however, the franchisee should be permitted to collect damages for the franchisor's violations of the disclosure law.

Although a disclosure law is an important step towards controlling franchise abuses, it is only a half-way measure.¹⁴⁸ Disclosure laws do nothing to protect the franchisee during the existence of the franchise relationship from abuses resulting from an overly-restrictive franchise agreement. As one commentator has stated with respect to the California disclosure law, "no matter how unfair the terms of the agreement, how inexperienced the franchisor or how unproven the product, the Commissioner would be powerless to prevent the sale as long as the franchisor makes a full disclosure."¹⁴⁹ Although disclosure informs the prospective franchisee and exposes the restrictive agreement before the contract is made,¹⁵⁰ many prospective franchisees become so involved with thoughts of their own business that they lose all objectivity, not fully analyzing or comprehending the significance of the disclosures. Thus the franchisee often consents to an overly-restrictive franchise agreement¹⁵¹ which is a product of inequality in bargaining power.¹⁵² The franchisee must either accept the standard contract presented to him or look elsewhere. The franchisee's interest almost inevitably leads him to accept the adhesion contract. Thus the need for substantive regulation during the life of the relationship remains.

D. *The Ongoing Franchise Relationship: Substantive Legislation*

Substantive regulation protects the franchisee during the period of the franchise relationship. The basic protection is often afforded by a "good faith" provision as exemplified by that of the Washington

¹⁴⁸ "Disclosure alone simply isn't enough. . . . In the securities field, where you have relatively sophisticated investors, disclosure works well. But in franchising investors usually aren't that sophisticated. You can make disclosures till you're blue in the face, but they alone won't solve the problems of franchise abuses." Clarke, Wash. State Assistant Attorney General quoted in Wong, In Absence of Federal Rules, More States Begin Regulating the Franchising Industry, Wall Street Journal, Oct. 11, 1971, at 22, col. 2.

¹⁴⁹ Comment, A Tempest in a Chicken Bucket: Some Reflections on Franchise Regulation in California, 17 U.C.L.A. L. Rev. 1101, 1128-29 (1970).

¹⁵⁰ Id.; see also IFA Position Paper, "Views of the International Franchise Association Relative to State Franchise Legislation" (1971) (on file in office of B.C. Ind. & Com. L. Rev.): "In contrast, disclosure legislation protects the franchisee by providing the information needed to select a franchise appropriate to his business abilities and a franchisor capable of and intending to implement its franchise program—without in any material way interfering with the right of the franchisor and the franchisee to define by agreement the terms of their legal relationship." Id. at 4.

¹⁵¹ H. Brown, Franchising: Trap for the Trusting 7 (1969).

¹⁵² Canadian Dept. of Financial & Commercial Affairs, Report of the Minister's Committee on Franchising, at 39 (1971) [hereinafter cited as Minister's Committee Report]. One franchisor's counsel has advised franchisee's counsel that the franchisee should be instructed that the franchise agreement constitutes an almost complete subordination of the franchisee's business and merchandising will to that of the franchisor. Katz, Franchising—Pro and Con, 76 Case & Com. No. 5, at 8, 9 (1971).

law: "The parties shall deal with each other in good faith."¹⁵³ It would appear that such a provision makes further regulation unnecessary.¹⁵⁴ However, this requirement, without specific guidelines, would be too ambiguous to be of practical value and would suffer from the litigation potential it affords. It is at best an expression of legislative intent which demonstrates the law's focus and purpose.

The Washington Act's requirement of good faith dealing between the parties is therefore supplemented by specification of conduct considered to be unfair or deceptive, or that comprising an unfair method of competition.¹⁵⁵ Prohibited conduct includes restricting the franchisee's right to join an association of franchisees. Since most franchisors discourage collective bargaining,¹⁵⁶ such a provision is necessary to provide franchisees with a "degree of equalization . . . in their negotiations and dealings with the franchisor."¹⁵⁷ Requiring the franchisee to purchase goods or services from the franchisor or from approved sources is also prohibited unless the franchisor can prove that such restrictive purchasing agreements are reasonably necessary for a lawful purpose, justified on business grounds, and that they do not substantially affect competition. In light of *Siegel v. Chicken Delight*,¹⁵⁸ this requirement is not only reasonable, it may save both franchisors and franchisees the expense and bother of protracted litigation. Despite the fact that most tying arrangements have long been considered violative of the antitrust laws, franchisors continue to employ such arrangements. The prohibition of tying arrangements in the Washington law, places the burden of proof on the franchisor to establish that the arrangement is *not* anticompetitive.¹⁵⁹ Failure to bear this burden may subject the franchisor to liability under the damage provisions of the Act. At the same time franchisees are protected, in most instances, from the costly abuses of kickbacks and overpriced items.

Another prohibited form of franchisor conduct is discrimination between franchisees with respect to royalties, goods, or services, unless the franchisor proves that the discrimination is reasonable, based on justifiable distinctions and not arbitrary. This substantive regula-

¹⁵³ Rev. Code Wash. Ann. ch. 252, § 18(1) (Supp. 1971). See also Cal. Assembly Bill 230, § 24(a) (1971) (to amend Cal. Corp. Code § 31250(a)); Mass. Senate Bill 110, § 5(a) (1971); Vt. Senate Bill 82, § 4(1) (1971).

¹⁵⁴ Statement of Harold Brown, app. B, Commentary on Proposed Franchise Fair Dealing Statute, (Mass. House Bill 2279), 1970 Hearings, *supra* note 122, at 2, 27 [hereinafter Brown, 1970 Hearings]. Although this statement was made with reference to the originally proposed Mass. bill, its provisions are substantially similar to the present Mass. proposal and the Wash. law.

¹⁵⁵ Rev. Code Wash. Ann. ch. 252, § 18(2) (Supp. 1971). See Cal. Assembly Bill 230, § 24(b) (1971) (to amend Cal. Corp. Code § 31250(b)); Mass. Senate Bill 110, §§ 4, 5(b) (1971); Vt. Senate Bill 82, § 4(2) (1971).

¹⁵⁶ Minister's Committee Report, *supra* note 152, at 39.

¹⁵⁷ Brown, *supra* note 151, at 93. See N.J. Assembly Bill 2063, § 8(b) (1971).

¹⁵⁸ 448 F.2d 43 (9th Cir. 1971).

¹⁵⁹ This provision may give certain procedural advantages to the plaintiff franchisee vis à vis an antitrust suit.

tion also applies to discriminatory termination attempts by a franchisor.¹⁶⁰ Successful franchisees are sometimes arbitrarily terminated in an attempt by the franchisor to take over a profitable operation and thereby obtain all the profits for himself. Also prohibited by the Washington statute is the sale or lease of any product or service for more than a fair and reasonable price. Thus if a franchisor is able to meet the "lawful purpose" and "insubstantial effect on competition" requirements of the Act and thereby able to require the franchisee to purchase certain goods or services from him, the franchisor must still deal fairly with the franchisee and charge only a reasonable price. However, determining a reasonable price will be difficult in such instances, since most of these goods and services will be unavailable elsewhere.

A further form of prohibited franchisor conduct is the obtaining of money or any other benefit from someone with whom the franchisee is doing business, unless such benefit is promptly accounted for and transmitted to the franchisee. This is a concerted attack on the kick-back problem¹⁶¹ which is said to be so prevalent that some suppliers make the payment to the franchisor by corporate check even without his demand.¹⁶² A forthright attempt at controlling such a blatant abuse is laudable.

A final provision prohibits the franchisor from competing with the franchisee or granting competitive franchises in the market area previously granted to another franchisee. One abuse this provision attempts to control is franchisor competition with a franchisee since "[d]irect competition by a franchisor at the same economic level as its franchisees is pregnant with every type of economic abuse, particularly when combined with pervasive control over the activities of the franchisees."¹⁶³ Another abuse this provision seeks to remedy, a practice which has been difficult to control, is the glutting of a territory by a franchisor with as many franchisees as possible.¹⁶⁴ Since the franchisor bases his royalty payments on a percentage of gross sales and not on a percentage of profit, he has no reason to be interested in whether the individual franchisees are able to show a profit.¹⁶⁵ The more outlets there are in a given area (up to a saturation point), the greater the likelihood of increased gross sales, even though each outlet suffers lower individual sales and smaller profits.

The remaining practices which are considered to be deceptive or unfair methods of competition under the Washington Act are: the requirement of a release from a franchisee, which would relieve any person from liability imposed by the law; the imposition on a fran-

¹⁶⁰ See Minister's Committee Report, *supra* note 152, at 42-43.

¹⁶¹ Brown, 1970 Hearings, *supra* note 154, at 36 (statement made with reference to a proposed Mass. provision identical to the provision in the recently enacted Wash. law).

¹⁶² Brown, *supra* note 151, at 16.

¹⁶³ Brown, 1970 Hearings, *supra* note 154, at 36.

¹⁶⁴ See also Fla. Stat. Ann. ch. 71-61 § 2(c) (Supp. 1971).

¹⁶⁵ Brown, 1970 Hearings, *supra* note 154, at 36.

chisee of a standard of conduct that is unreasonable or unnecessary; and the termination or failure to renew a franchise without just cause.¹⁶⁶

Similarly, a proposed New Jersey franchise law would prohibit the granting of an additional franchise in an established franchisee's designated geographical area "unless the franchisor shall give to the existing franchisee 180 days notice of its intention to grant an additional franchise and such franchisee shall have failed to substantially comply with reasonable and nondiscriminatory requirements imposed upon him by the franchise, the burden of proving such failure being upon the franchisor."¹⁶⁷ Since failure to comply with reasonable and nondiscriminatory franchisor requirements is also the basis for justified termination under the New Jersey law,¹⁶⁸ the question arises why the franchisor is permitted to add an additional franchise in the same geographical area instead of terminating the first franchise agreement and then making a new agreement with a second franchisee. The purpose of the law, it seems, is to give the franchisor an opportunity to establish a new franchisee in the geographical area before terminating the noncomplying franchisee. This prevents a period during which no franchisee is operating in the geographical area and the resulting loss of customers to a competing franchising system.

It would appear, however, that the rights of the entering franchisee are ignored if the franchisor, having established a new franchise, is permitted to transfer the previously existing franchise to a second franchisee. In light of the law's purpose, the franchisor should not be permitted to transfer, take over, or refuse to terminate the noncomplying franchisee's franchise once a new franchise has been established. Rather, the franchisor must be considered as having elected to terminate the noncomplying franchisee by instituting a new franchise in the area. Upon termination of the noncomplying franchisee, the provisions of the law prohibiting establishment of an additional franchise in a geographical area would apply and the rights of the entering franchisee would thereby be protected.

The Massachusetts proposal, a good part of which was used as a basis for the Washington law, goes further than the Washington law in its attempt to protect the franchisee during his relationship with the franchisor. The Massachusetts Franchise Fair Dealing Act, for the most part similar to the Washington law, at the outset imposes a requirement of good faith dealing by the parties.¹⁶⁹ Going beyond the scope of the Washington law, the Massachusetts bill details the rights of the franchisees to bargain collectively, permits their selection of a collective bargaining agent, requires the franchisor to bargain collectively with the agent selected by the franchisees and encourages the use

¹⁶⁶ For a discussion of termination see p. 558 *infra*.

¹⁶⁷ N.J. Assembly Bill 2063, § 7 (1971).

¹⁶⁸ N.J. Assembly Bill 2063, § 5 (1971); See discussion p. 561 *infra*.

¹⁶⁹ Mass. Senate Bill 110, § 5(a) (1971).

of collective bargaining by associations of franchisees.¹⁷⁰ In addition, the Massachusetts proposal provides that the federal antitrust laws as construed by the federal courts govern the relations of the parties; that it is unlawful for the franchisor to impose unreasonable restrictions having to do with transfer, sale, renewal, or termination; that the defense of "unclean hands" is not available to the franchisor, and that in any proceeding, the damages caused by the franchisor's violation of the Act be given weight.¹⁷¹

Arkansas recently enacted a brief statute dealing with the ongoing franchise relationship. The law represents an attempt to end unfair discrimination in franchise fees among franchisees,¹⁷² an abuse no other state has yet sought to control. The relevant section provides:

It shall be unlawful for a franchisor to charge an Arkansas Franchisee a royalty fee for use of a service mark, trade mark, or trade name which is greater than the lowest royalty fee it charges to any other of its franchisees in the United States.¹⁷³

Buttressing this requirement is an enforcement provision imposing a fine of up to one thousand dollars for each violation and permitting recovery of treble damages by any franchisee harmed by violation of the provision.¹⁷⁴ Some experts, however, believe that this law cannot be constitutionally applied to existing franchise relationships¹⁷⁵ because it would abridge the "contract clause" of the United States Constitution.¹⁷⁶

Three major factors must be weighed in determining whether a statute violates the contract clause: "the nature and strength of the public interest served by the statute, the extent to which the statute modifies or abrogates the asserted preenactment right, and the nature of the right which the statute alters."¹⁷⁷ Since the Arkansas Act is declared to be an emergency measure, it could be found to be a "proper occasion for the exercise of the reserved power of the State to protect the vital interests of the community,"¹⁷⁸ and hence constitutional. Not permitting a franchisor to charge a franchisee in the legislating state a greater royalty fee than that charged any other franchisee may be a reasonable legislative measure within a state's police power.¹⁷⁹

¹⁷⁰ Mass. Senate Bill 110, § 6 (1971). See Vt. Senate Bill 82, § 5 (1971).

¹⁷¹ Mass. Senate Bill 110, § 5 (1971).

¹⁷² Cf. Brown, *supra* note 151, at 11.

¹⁷³ Ark. Act 252 of 1971, § 2 (1971) (Ark. House Bill 346, § 2 (1971)).

¹⁷⁴ Ark. Act 252 of 1971, § 6 (1971).

¹⁷⁵ See Report of Lewis Rudnick, 4th Annual Franchising and Government Symposium of the IFA, May 17, 18 and 19, 1971, at 29 (Report on file in office of B.C. Ind. & Com. L. Rev.).

¹⁷⁶ U.S. Const. art. 1, § 10 provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts . . ."

¹⁷⁷ C. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692, 697 (1960).

¹⁷⁸ *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 444 (1934).

¹⁷⁹ Cf. Hale, *The Supreme Court and the Contract Clause* (pts. 1-3), 57 Harv. L. Rev. 512, 621, 852 at 884-87 (1944).

The Texas approach to substantive regulation may also be compared to that of Washington. Whereas the basis of the Washington law is a good faith provision supplemented by specific guidelines, the Texas law employs a good faith requirement which incorporates existing standards of conduct. The Texas bill requires that

the franchisor and the franchisee shall prior and subsequent to the execution of a binding franchise or other agreement have the mutual obligations to deal fairly, openly, honestly, and in good faith and to exercise reasonable care and diligence in complying with all provisions of the franchise and other agreements between them.¹⁸⁰

This provision imposes upon the parties mutual obligations of a fiduciary nature; thus well-recognized principles govern their conduct. This approach does not focus on specific franchise abuses but deals in general terms and so creates some difficulty; although in theory the protections provided by fiduciary obligations are available to the franchisee, they often are not sufficiently well known or understood by the franchisee (who may not be represented by counsel), and thus the fiduciary obligations may not be observed in practice.

E. *The Franchise Relationship Ends: Termination Legislation*

Although termination and nonrenewal are merely one type of franchisor abuse requiring substantive regulation, they have been considered by some legislatures to be of such importance that they have been given singular and separate attention. The first state law to deal with franchise terminations was the Delaware Franchise Security Law,¹⁸¹ enactment of which was marked by derision¹⁸² and criticism that it would stunt the growth of franchising capital in Delaware.¹⁸³ The stated purpose of the law is protection of franchised distributors from threatened and actual termination by suppliers and licensors "on short notice without just cause."¹⁸⁴ The law provides that a franchisor shall not "unjustly terminate a franchise"¹⁸⁵ or "unjustly fail or refuse to renew a franchise."¹⁸⁶ Termination or nonrenewal is considered unjust if made without good cause or in bad faith.¹⁸⁷ In addition, the law provides remedies for a franchised distributor whose franchisor unjustly terminates, refuses to renew, threatens to terminate, or threat-

¹⁸⁰ Tex. Senate Substitute House Bill 709, § 18.06 (1971).

¹⁸¹ Del. Code Ann. tit. 6, §§ 2551-57 (Supp. 1971). See also P.R. Laws Ann. tit. 10, § 278a (Supp. 1970).

¹⁸² Rudnick, *supra* note 175, at 2.

¹⁸³ Pelletier & Strauser, *Franchise Legislation*, in *Franchise Litigation and Legislation* 205, 209 (G.A. Pelletier & H. Brown eds., P.L.I., 1971).

¹⁸⁴ Preamble to 57 Del. Laws, ch. 693 in 6 Del. Code Ann. at § 2551 (Supp. 1970).

¹⁸⁵ Del. Code Ann. tit. 6, § 2552(g) (Supp. 1970).

¹⁸⁶ Del. Code Ann. tit. 6, § 2552(h) (Supp. 1970).

¹⁸⁷ Del. Code Ann. tit. 6, § 2552(a), (b) (Supp. 1970).

ens to refuse to renew a franchise; remedies include damages and the right to secure an injunction.¹⁸⁸

Two problems were originally seen in the Delaware law. Franchisee wholesalers appeared subject to the provisions of the law but franchisees who offered services to the public appeared to be excluded.¹⁸⁹ In addition, damages proposed in the relief section were "so excessively generous to franchisees as practically to invite judicial evasion."¹⁹⁰ These underlying problems were cited by the Delaware Supreme Court in *Globe Liquor Co. v. Four Roses Distillers Co.*,¹⁹¹ although they were not the basis for that decision. The major problem with the Delaware law was its conflict with the contract clause of the federal Constitution, and it was on this ground that the *Globe Liquor* court declared much of the law unconstitutional.¹⁹²

In *Globe Liquor*, Four Roses Distillers Co. had granted Globe Liquor Co. a franchise to distribute Four Roses' products in Delaware. The contract provided for automatic expiration one year after inception. One month prior to the expiration date Globe was notified that Four Roses did not intend to renew the franchise agreement. Globe brought an action contending that the Delaware Franchise Security Law prohibited a unilateral termination and requesting both damages and injunctive relief.

The Court of Chancery certified four questions of law for decision by the Supreme Court of Delaware. The questions included whether the Delaware Franchise Security Law violated Section 7¹⁹³ or 8¹⁹⁴ of Article I of the Delaware Constitution, or Article I, Section 10¹⁹⁵ or the Fourteenth Amendment¹⁹⁶ of the United States Constitution. Four Roses had argued that, under Article I, Section 7 of the Delaware Constitution and the Fourteenth Amendment of the United States Constitution the Delaware Franchise Security Law should be found unconstitutional as vague and indefinite and thus as depriving a franchisor of property without due process of law. The Delaware Supreme Court disagreed, believing that the statutory standards of "good cause" and "bad faith" have a well-settled meaning in law "even though there could be differences of opinion as to elements of degree."¹⁹⁷ The court

¹⁸⁸ Del. Code Ann. tit. 6, § 2553(a) (Supp. 1970). Ninety days' notice must be given in any case before termination or failure to renew. Id. at § 2554.

¹⁸⁹ Pelletier & Strauser, *supra* note 183, at 208.

¹⁹⁰ Id. at 209.

¹⁹¹ — Del. —, 281 A.2d 19, 23 (1971); cert. denied, — U.S. —, 92 S.Ct. 103 (1971).

¹⁹² Id. at —, 281 A.2d at 21.

¹⁹³ "In all criminal prosecutions, the accused . . . shall [not] be deprived of . . . property, unless by the judgment of his peers or the law of the land." Four Roses argued that this section was applicable because the damage provisions of the Delaware Franchise Security Law were punitive measures.

¹⁹⁴ "No . . . man's property [shall] be taken or applied to public use without the consent of his representatives, and without compensation being made."

¹⁹⁵ "No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . ."

¹⁹⁶ "No State shall . . . deprive any person of . . . property, without due process of law. . . ."

¹⁹⁷ — Del. —, 281 A.2d at 22.

concluded that this settled meaning was sufficient to establish an "intelligible standard of conduct."¹⁹⁸

Four Roses also argued that the distinction between wholesale and retail franchises made by the Law violated the Fourteenth Amendment as well as the Delaware Constitution, because it was arbitrary and without justification in light of the statutory purpose. The court again disagreed, upholding the classification on the basis that there were sufficient, though unspecified, facts to show that the classification was reasonable in light of the law's purpose.¹⁹⁹ Four Roses' main argument, and the one upon which the case turned, was that the Franchise Security Law impaired the obligations of a contract and thus violated Article I, Section 10 of the United States Constitution. The court agreed, noting that the statutory damages were "savagely punitive" and were recoverable even absent proof by the terminated franchisee of any actual damages.²⁰⁰ The court determined that the law provided a cause of action based on a mere threat to terminate.²⁰¹ The court concluded:

We think the Delaware Franchise Security Law . . . makes a substantive change in the rights and obligations under this contract. These substantive changes are the imposition on Four Roses of the obligation to deal with Globe indefinitely, and the imposition of a penalty in the form of damages if it attempts to insist on its contractual rights. It is therefore not a minor change or infringement permissible under the exercise of the police power. It is therefore proscribed by the Contract Clause of the Federal Constitution.²⁰²

Other states addressing themselves to the termination problem face the serious question whether a law can be drafted that will be upheld as constitutional and still be strong enough to protect franchisees. The biggest problem facing the state legislatures does not arise so much from termination as from the failure to renew. A franchisor, in attempting to terminate, is in a sense breaking the franchise relationship. Although there may be provisions in the contract permitting termination, if these provisions are unreasonable a court would find little difficulty in refusing to enforce the provisions in light of legislative attempts to remedy the problem of unjust termination.²⁰³ On the other hand, a

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* at —, 281 A.2d at 22-24.

²⁰⁰ *Id.* at —, 281 A.2d at 21.

²⁰¹ These facts also led the court to conclude that the damages allowed by the statute amounted to a taking of private property without compensation and without due process of law. *Id.* at —, 281 A.2d at 24.

²⁰² *Id.* at —, 281 A.2d at 21.

²⁰³ See Gellhorn, *Limitation on Contract Termination Rights—Franchise Cancellation*, 1967 Duke L.J. 465 (1967). But see *Fornaris v. Ridge Tool Co.*, 423 F.2d 563 (1970) (holding that a Puerto Rican law which prohibited a manufacturer from terminating or refusing to renew a dealership except for "just cause," regardless of the provisions of the contract, and which provided substantial damages in case of a violation, gave rise to constitutionally impermissible retroactive alteration of contractual provisions).

refusal to renew a franchise, even if not based on just cause, can hardly be considered unreasonable per se. To prohibit refusals to renew in effect creates a contract of indeterminate duration.²⁰⁴ As the Delaware court found, this would substantially change the rights and obligations of the parties under the contract.²⁰⁵

The recently enacted New Jersey termination law contains provisions similar to those of the Delaware law.²⁰⁶ It requires sixty days' notice detailing the reasons for the termination or refusal to renew, but grants as a complete defense the right to terminate for good cause.²⁰⁷ The statute defines good cause to mean failure by the franchisee substantially to comply with those requirements imposed upon him by the franchise, requirements which must be reasonable and nondiscriminatorily enforced. The institution of this "complete defense" creates some ambiguity, however. For instance, it is not clear whether the franchisor with good cause to terminate must still comply with the sixty days' notice requirement, or whether the franchisor who gives the sixty days' notice must still have good cause to terminate. "It is probable that the good cause defense is limited to the legality of the termination or refusal to renew, with the 60 days advance notice required whether or not the franchisor has good cause."²⁰⁸

There are two exceptions, however, to the notice requirement. In those instances in which the franchisee voluntarily abandons the franchise relationship, written notice may be given fifteen days in advance of termination or nonrenewal; and if the franchisee was convicted of an offense directly related to the business conduct of the franchise, termination or refusal to renew may be effective immediately upon the delivery and receipt of written notice at any time following the conviction.²⁰⁹ By way of remedies, New Jersey provides for assessment of damages and injunctive relief.²¹⁰

The pending Connecticut bill is substantially similar to the New Jersey law's termination sections, requiring written notice together with a statement of the reasons for the termination or nonrenewal.²¹¹ The Connecticut bill specifically requires that no franchisor terminate, cancel or fail to renew a franchise except for due cause.²¹² It should be noted that both the New Jersey law and the Connecticut bill follow the Delaware approach and apply the same limitations on terminations and refusals to renew as were struck down in the latter state. Regard-

²⁰⁴ Rudnick, *supra* note 175, at 21.

²⁰⁵ *Globe Liquor Co. v. Four Roses Distillers Co.*, — Del. —, 281 A.2d 19, 21 (1971).

²⁰⁶ N.J. Assembly Bill 2063 (1971) (passed by both Houses but unsigned by the Governor).

²⁰⁷ N.J. Assembly Bill 2063, § 5 (1971).

²⁰⁸ Rudnick, *supra* note 175, at 24.

²⁰⁹ N.J. Assembly Bill 2063, § 5(1)(2) (1971).

²¹⁰ N.J. Assembly Bill 2063, § 11 (1971) (as enacted, the treble damages provision was removed).

²¹¹ Conn. Substitute Senate Bill 1474, § 2 (1971).

²¹² Conn. Substitute Senate Bill 1474, § 3 (1971).

less of whether such limitations are desirable, they are unconstitutional according to the Delaware Supreme Court.

Massachusetts goes even further with this approach of questionable validity:

It shall be unlawful directly or indirectly to:

- (1) Harass, intimidate, or coerce a franchisee to enter into any agreement or to do or refrain from doing any other act prejudicial to the franchisee or to accomplish such result by threatening to cancel or to fail to renew any franchise or any existing contractual agreement. . . .
- (2) Terminate or cancel the franchise of any such franchisee without due cause. The nonrenewal of a franchise without due cause shall constitute an unfair termination or cancellation, regardless of the terms or provisions of such franchise. Such franchisor shall notify a franchisee in writing, and forward a copy of such notice to the attorney general . . . at least sixty days before the effective date . . . and in no event shall the contractual term of any such franchise expire, without the written consent of the franchisee involved, prior to the expiration of at least sixty days following such written notice.²¹³

Thus the Massachusetts law is almost entirely favorable to the franchisee and presents potentially greater violations of the contract clause than those in the Delaware law.

Perhaps the only state law restricting termination that has any possibility of surviving a constitutional attack is the Washington Franchise Investment Protection Act. It provides that both failure to renew and termination are permissible for

just cause, or in accordance with the current terms and standards established by the franchisor then equally applicable to all franchisees, unless and to the extent that the franchisor satisfies the burden of proving that any classification of or discrimination between franchisees is reasonable, is based on proper and justifiable distinctions considering the purposes of this act, and is not arbitrary.²¹⁴

The franchisor may thus terminate or refuse to renew a franchise even though the grounds for such action would be considered unjust, if the action is not applied discriminatorily against individual franchisees. If a franchisor refuses to renew the franchise of an *individual* franchisee, the statute requires justification by the franchisor of this discriminatory action. As long as the franchisor can show that the

²¹³ Mass. Senate Bill 110, § 5(b)(1)(2) (1971).

²¹⁴ Rev. Code Wash. Ann. ch. 252, § 18(2)(i), (j) (Supp. 1971).

discrimination between franchisees is reasonable, and based on proper and justifiable distinctions, his refusal to renew will be upheld even if the franchisor does not have "just cause."

Under the Washington law a franchisor is thus not required to deal "indefinitely" with a franchisee. The only requirement is that all franchisees be treated equally—a reasonable regulation and perhaps one that does not violate the contract clause. The Washington law additionally provides that upon termination the franchisee shall receive compensation for his inventory, supplies, equipment, furnishings, and any prepaid costs and expenses paid to the franchisor.²¹⁵ This provision mitigates the financial shock of termination and avoids unjust enrichment of the franchisor. There is no similar provision for the nonrenewed franchisee. This is not necessarily a weakness, however, because the nonrenewed franchisee should have been amortizing the cost of these items over the contract period and his reasonable expectations are not the same as those of a terminated franchisee.

The numerous problems caused by terminations and refusals to renew are difficult to remedy. This difficulty is compounded by the proscriptions of the contract clause in the federal Constitution. Although perhaps the Washington law presents the most viable regulation in this area, other possible solutions should be examined. One such possibility is the stipulation of a reasonable time limit or probationary period within which the franchisor can either terminate or refuse to renew in accordance with the contract. The evils of the termination context are the use of threats of termination to force franchisee compliance with objectionable franchisor demands and the use of actual termination as a method of taking over profitable franchises. Therefore the probationary period should be short enough to insure that neither use can remain a viable possibility, yet long enough to grant the franchisor an opportunity to observe the new franchisee and to decide whether continuation will be mutually beneficial. Eighteen months should be a sufficient amount of time for the franchisor to make such a decision and yet not a long enough period for him to be able to use the threat of termination in his attempts to control the franchisee. Furthermore, this period is not long enough for the franchisor to determine that the franchise will be so profitable that it is worth taking over. After the eighteen-month probationary period the franchisor would be permitted to terminate a franchise only for just cause.

Since the difficulty that states have in regulating refusals to renew is in attempting to do so without violating the contract clause, some reasonable balance must be reached between the right of the franchisor to refuse to continue the contract indefinitely and the franchisee's interests. Provision for a probationary period may provide this balance; up to the end of the period it may be assumed that the franchisee could not have built up a substantial equitable interest in the business and thus both parties should abide by their agreement that the contract

²¹⁵ Rev. Code Wash. Ann. ch. 252, § 18(2)(j) (Supp. 1971).

end. After the probation period, however, the interests of the franchisee, particularly in the goodwill he has developed, would be assumed to outweigh the rights of the franchisor protected by the contract clause; therefore the franchisor should not be allowed to refuse to renew the franchise except for good cause. It is not unlikely that a court would take notice of the legislature's attempt to differentiate between those franchisees which have built up a sufficient interest in the franchise to require protection and those which have not. The court could recognize this attempt to balance the rights of franchisors and franchisees as a "proper occasion for the exercise of the reserved power of the State to protect the vital interests of the community,"²¹⁶ and therefore find that the statute does not violate the contract clause.

Another possible solution to the termination problem may be to permit both terminations and refusals to renew in any case but to grant the terminated or nonrenewed franchisee damages equal to the goodwill he has built up in the franchise. This would permit the franchisor to use his own discretion in determining which franchisees to retain. Since there is no requirement to deal indefinitely, but only a provision that reasonable compensation be made for the goodwill value built up by the terminated or nonrenewed franchisee, there would be no violation of the contract clause. Whatever solution is accepted, however, the franchisee should not be entitled to damages for the mere threat of termination or nonrenewal by the franchisor. If the franchisor is not allowed arbitrarily to terminate or fail to renew, or if the franchisee is compensated for his equitable interest upon termination or nonrenewal, a threat of such action can have no damaging effect on the franchisee.

IV. THE FEDERAL PROPOSALS

Although this survey has dealt with state franchise legislation, the federal legislative proposals of Senators Williams and Hart and the recently proposed Trade Regulation Rule of the Federal Trade Commission (FTC) should be briefly examined for comparison purposes, and possibly as preemptive regulation. Senator Williams' proposed Franchise Fair Practices Act of 1971 would employ the FTC to supervise the public disclosures required of all franchisors under the Act.²¹⁷ The exemption provision of the bill is similar to the New York exemption provision. It grants substantial discretion to the Commission in determining which franchisors to exempt from the public disclosure requirements.²¹⁸ The disclosures required by the Williams bill are essentially the same as, although not identical to, those required by the California and Washington disclosure laws. Some additional provisions in the federal law that are of particular interest are the requirement of a statement of the length of time neces-

²¹⁶ *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 444 (1934).

²¹⁷ S. 2399, 92d Cong., 1st Sess. (1971). See 117 Cong. Rec. 12,775 (daily ed. Aug. 2, 1971).

²¹⁸ S. 2399, 92d Cong., 1st Sess. § 4 (1971).

sary to obtain the franchise, including the average length of time between the signing of a franchise agreement and the opening of the franchised outlet; a statement of the number of franchisees that operated at a loss during the previous year; a statement, subject to limitations by the Commission, of available earnings of past and present franchises; and an objective analysis of the performance of franchises which details franchise failures and resales to the franchisor.²¹⁹

The FTC may issue an order suspending the effectiveness of the disclosure statement if at any time it finds false or misleading statements or omissions of a material fact in the disclosure.²²⁰ Awards of treble damages, attorney fees and court costs are available to private litigants prejudiced by such false or misleading statements or omissions, or who are the victims of any unfair or deceptive act or practice prohibited by the act.²²¹ That this proposed federal disclosure legislation is more stringent than the state disclosure laws is indicated by the lack of specific exemptions and the requirement of more specific disclosures.

On November 10, 1971, the FTC proposed a Trade Regulation Rule substantially similar to the Williams bill. The proposed regulation has as its final required disclosure "[a] statement explaining clearly the terms and effects of any covenant not to compete which a franchisee may be required to enter into."²²² Neither the Williams bill nor any state disclosure legislation requires a similar disclosure. Since, as previously mentioned, most prospective franchisees do not consider the consequences which the restrictive franchise agreement may have upon them during the contract period, they probably do not consider the consequences the agreement may have on the period following the end of the relationship. Thus the need arises for such a disclosure. The proposed FTC Rule also requires a statement, in bold face print, granting the prospective franchisee a ten day cooling off period during which he may cancel the contract for any reason and receive a full refund.²²³

The essential difference between the proposed FTC regulation and the Williams bill, however, is in the area of remedies. The FTC Rule provides that a failure to comply with any requirement imposed by the regulation will be a violation of Section 5 of the Federal Trade Commission Act (FTCA).²²⁴ The Williams bill, on the other hand, provides civil remedies to the defrauded franchisee in addition to any remedies available to the Commission under the FTCA.²²⁵ Thus, although the franchisee is protected by the required disclosures of the proposed

²¹⁹ Id. at § 7(15), (21), (23).

²²⁰ Id. at § 6(d).

²²¹ Id. at § 9(c).

²²² FTC Proposed Trade Regulation Rule Involving Disclosure Requirements and Prohibitions Concerning Franchising, 5 Trade Reg. Rep. ¶ 50,310, at 55,657, ¶ (27) (Nov. 10, 1971).

²²³ Id. at 55,657.

²²⁴ Id. at 55,656.

²²⁵ S. 2399, 92d Cong., 1st Sess. §§ 9, 11 (1971).

FTC Rule, he has no private remedy if he is damaged because of a violation of the Rule. This deficiency in the proposed FTC regulation may require remedial legislation. The proposed rule is not "intended to abrogate or supersede any State laws imposing the same or more stringent requirements . . ."²²⁶ and therefore state legislation may provide private remedies if Congress does not.

Although federal disclosure regulation is an important step toward the control of franchise abuses, it is not a complete solution. There have been no federal proposals for comprehensive substantive regulation of the franchise relationship, although there have been attempts to deal with the termination problem. The 1971 version of Senator Hart's "Fairness in Franchising Act" presents the federal version of termination legislation. The bill prohibits cancellation, termination or refusal to renew by the franchisor except for good cause and legitimate business reasons.²²⁷ Senator Hart contends that the bill would allow termination even if the franchisor merely wants to take over the business himself, provided, however, that reasonable compensation is paid for the franchisee's business, including the goodwill. This is a questionable conclusion in light of the express language of the bill.²²⁸ The above prohibition would not apply, however, if the written franchise agreement contained provisions for the binding arbitration of disputes in accordance with the rules of the American Arbitration Association.²²⁹ This exemption is similar to that provided in the proposed Connecticut termination bill. The Hart bill also requires ninety days' notice prior to any termination or nonrenewal action by the franchisor.²³⁰ As in the Delaware law, the bill allows damages for the mere threat of termination, cancellation or refusal to renew.²³¹ Damages, however, must be shown to have been sustained by the franchisee.²³² As the court in *Globe Liquor* stated: "it is difficult to visualize . . . any damage flowing merely from a threat to terminate. . . ."²³³

CONCLUSION

The franchise relationship subjects the franchisee to extensive abuses from the moment the relationship begins until long after it ends. The traditional actions for fraud and antitrust violations as well as regulation through the securities laws have failed satisfactorily to

²²⁶ FTC Proposed Trade Regulation Rule Involving Disclosure Requirements and Prohibitions Concerning Franchising, 5 Trade Reg. Rep. ¶ 50,310, at 55,658, Note I (Nov. 10, 1971).

²²⁷ S. 2472, 92d Cong., 1st Sess. § 4 (1971) found in 117 Cong. Rec. 13502 (daily ed. Aug. 6, 1971).

²²⁸ See 117 Cong. Rec. 13501-02 (daily ed. Aug. 6, 1971). The bill requires *both* good cause *and* legitimate business reasons.

²²⁹ S. 2472, 92d Cong., 1st Sess. § 5 (1971).

²³⁰ *Id.* at § 3.

²³¹ *Id.* at § 4.

²³² *Id.* at § 7.

²³³ *Globe Liquor Co. v. Four Roses Distillers Co.*, — Del. —, 281 A.2d 19, 21 (Del. 1971).

remedy these abuses. The inadequacies of these remedies created an urgent need for direct legislation to regulate the franchise field. Enacted and proposed state legislation has taken three approaches and has attempted to remedy three distinct areas of abuse: disclosure legislation attempts to inform the prospective franchisee of his rights under the contract prior to his entry into it; substantive regulation attempts to protect the franchisee during the contract period; finally, termination legislation attempts to deal with the special problems created by termination and refusal to renew.

The proposed FTC Rule and federal bills offer uniformity to what may become a patchwork of state legislation. This uniformity alone is sufficient to warrant the enactment of these federal proposals. Until federal legislation or regulation is forthcoming, however, the states must continue to regulate independently, basing their own legislation upon the experiences of states that have already legislated.

Among the legislation surveyed in this comment, the Washington law appears to be the most comprehensive and equitable law to date; it deals most comprehensively with the abuses confronting the franchisee. It provides the most balanced definition of "franchise" of any that has been proposed. It provides registration of the franchise and requires disclosure directly to the prospective franchisee in order to assist him in his determination of whether to purchase a franchise. This law also provides substantive regulation of the franchise relationship in an attempt to equalize the bargaining strength of the two parties. Finally, to date the Washington law presents the most realistic approach to termination regulation. Its only drawback is that it permits franchisors requiring large investments to be exempt from the disclosure requirements.

It is regrettable that the International Franchise Association was able to postpone the effective date of the Washington law for an entire year²³⁴ in an attempt to have it repealed.²³⁵ Such action on the part of franchisor-oriented groups promotes and prolongs the unfair and abusive treatment to which many franchisees have been subjected. It also underscores both the reason and the necessity for governmental regulation if the franchise method of operation is to have "the advantage . . . of enabling numerous groups of individuals with small capital to become entrepreneurs."²³⁶

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²³⁴ The Washington law does not become effective until May, 1972. Rev. Code Wash. Ann. ch. 252, § 30 (Supp. 1971).

²³⁵ This "major attack on the bill" is currently taking place. Wong, In Absence of Federal Rules, More States Begin Regulating the Franchising Industry, Wall Street Journal, Oct. 11, 1971, at 22, col. 3.

²³⁶ *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y. 1962); *aff'd*, 332 F.2d 505 (2d Cir.), cert. granted, 379 U.S. 885 (1964), cert. dismissed as improvidently granted, 381 U.S. 125 (1965).